

# PART-III

## GUIDANCE NOTE ON INDEPENDENCE OF AUDITORS (REVISED)\*

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### 1. INTRODUCTION

1.1 This Guidance Note aims to clarify the meaning of independence while performing their duties as Auditors. Professional integrity and independence is an essential characteristic of all the professions but is more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him, or to his own self-interest. This document shall provide guidance to members about the specific circumstances and relationships that may create threats to independence. The Guidance Note also provides safeguards that should be employed by the auditors to mitigate the risk arising from such circumstances and relationship leading to the threats to independence.

1.2 It is not possible to define "independence" precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered.

1.3 There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance.

The Code of Ethics for Professional Accountants, issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:

"Independence is:

- (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and
- (b) Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably

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\* Issued in January, 2005. This Guidance Note replaces the Guidance Note published in 'The Chartered Accountant', June 1968, p. 670-672.

### III.2 Auditing Pronouncements

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**conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised."**

1.4 Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly, he is himself satisfied about his independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors' independence.

1.5 In all phases of a Chartered Accountant's work, he is expected to be independent, but in particular in his work as auditor, independence has a special meaning and significance. Not only the client but also the stakeholders, prospective investors, bankers and government agencies rely upon the accounts of an enterprise when they are audited by a Chartered Accountant. As statutory auditor of a limited company, for example, the Chartered Accountant would cease to perform any useful function if the persons who rely upon the accounts of the company do not have any faith in the independence and integrity of the Chartered Accountant. In such cases he is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work such as his training and experience enables him to do so.

1.6 The objective of an audit of financial statements, prepared within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

1.7 The idea of independence is instilled in the minds of Chartered Accountants from the commencement of their training under articles or audit service. It has to be applied in their day-to-day work and their success is dependent entirely upon their integrity, competence and independence of approach.

1.8 Dependent as it is on the state of mind and character of a person, independence, is a very subjective matter. One person might be independent in a particular set of circumstances, while another person might feel he is not independent in similar circumstances. It is therefore the duty of every Chartered Accountant to determine for himself whether or not he can act independently in the given circumstances of a case and quite apart from legal rules, in no case to place himself in a position which would compromise his independence.

1.9 The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity. This is not self evident in the exercise of the reporting function but also applies to all other professional work. In determining whether a member in practice is or is not seen to be free of any interest which is incompatible with objectivity, the criterion should

be whether a reasonable person, having knowledge of relevant facts and taking into account the conduct of the member and the member's behaviour under the circumstances, could conclude that the member has placed himself in a position where his objectivity would or could be impaired.

1.10 While performing audit functions, maintaining quality control is the objectives of the quality control and policies to be adopted by an Auditor shall ordinarily incorporate the following:

- (a) **Professional Requirements:** Personnel in the firm are to adhere to the principles of Independence, Integrity, Objectivity, Confidentiality and Professional Behaviours.
- (b) **Skills and Competence:** The firm is to be staffed by personnel who have attained and maintained the Technical Standards and Professional Competence required to enable them to fulfill their responsibilities with Due Care.
- (c) **Assignment:** Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
- (d) **Delegation:** There is to be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.
- (e) **Consultation:** Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.
- (f) **Acceptance and Retention of Clients:** An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly are to be considered.
- (g) **Monitoring:** The continued adequacy and operational effectiveness of quality control policies and procedures is to be monitored.

1.11 A member not in practice has a duty to be objective in carrying out his or her professional work whether or not the appearance of professional independence is attainable. Thus a member performing professional work must recognize the problems created by personal relationships or financial involvement, which by reason of their nature or degree might threaten his independence.

1.12 Standing alone, the word "Independence" may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

1.13 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of

### III.4 Auditing Pronouncements

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assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires chartered accountants to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules in the public interest.

#### 2. THREATS TO INDEPENDENCE

2.1 The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

1. *Self-interest threats*, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.
2. *Self-review threats*, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.
3. *Advocacy threats*, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.
4. *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. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.
5. *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.

### 3. SAFEGUARDS TO INDEPENDENCE

3.1 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.

3.2 To address the issue, Members are advised to apply the following guiding principles:

- 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.
- In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
- Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
- When such threats exist, the auditor should either desist from the task or, at the very least, put in place safeguards that eliminate them. All such safeguards measure needs to be recorded in a form that can serve as evidence of compliance with due process.
- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

#### 3.3 *Provisions contained under the Companies Act, 1956*

3.3.1 In order to ensure independence, the law has made certain provisions which either prohibit the appointment of a person as auditor in certain circumstances or place certain restrictions on his appointment as auditor or put third parties on guard against the possibility of an abridgement of independence by requiring certain disclosures to be made. These provisions are briefly outlined below:

3.3.2 Section 226 of the Companies Act, 1956 prohibits the appointment of a Chartered Accountant as auditor of a Company if he is:

- (i) an officer or employee of the Company;
- (ii) a partner of a person in the employment of an officer or of an employee of the Company;
- (iii) a person who is indebted to the company for an amount exceeding Rs. 1000;
- (iv) a person who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs. 1000;
- (v) a person holding any security of that company.

3.3.3 A person who is disqualified from becoming auditor of any body corporate under the above rules is also disqualified from appointment as auditor of such body's subsidiary, co-subsidiary or holding company.

3.3.4 Section 314 of the Companies Act, 1956 makes separate provision for the case where an auditor of a Company (whether public or private) is a relative of a director, or manager of a private company of which the director of the company is a director or member. In the case of

### III.6 Auditing Pronouncements

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such a person he may be appointed as auditor of a company only if such appointment is approved with the consent of the company in general meeting obtained by a special resolution.

3.3.5 It will be observed from the above that the Act has specifically provided for cases where the independence of an auditor may be affected by his connection with the company and prohibited or restricted him from acting as auditor under those circumstances.

3.3.6 A question often arises as to whether an indebtedness (as referred in para (iii) above) arises in cases where in accordance with the terms of his engagement by a client (e.g. resolution passed at the general meeting) the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job. In these circumstances, where in accordance with such terms the auditor recovers his fees on a progressive basis he cannot be said to be indebted to the company at any stage.

3.3.7 A question of indebtedness may also be raised where an auditor of a company purchases goods or services from a company audited by him. In such a case, if the amount outstanding exceeds Rs. 1000/- irrespective of the nature of the purchase or period of credit allowed to other customers the provisions concerning disqualification of auditor as contained in Section 226 (3)(d) of the Companies Act, 1956 will be attracted.

3.3.8 Another question which arises for consideration is whether a partner is disqualified from appointment as auditor when the firm of which he is a partner is indebted to the company in excess of the limit prescribed and whether the firm is disqualified from appointment as auditor when a partner of the firm is indebted in excess of the prescribed limit. In both cases, the disqualification will apply, because when a firm is appointed as auditor, each partner is deemed to be so appointed and when a firm is indebted, each partner is deemed to be indebted.

3.3.9 There may also be situations in which, though the appointment is in the individual name of a partner, the work, is, in fact, carried out by the firm and the fees are credited to the account of the firm. In such situations, the firm will be deemed to be acting as auditor and the disqualification will be attracted.

#### ***3.4 Provisions contained under the Chartered Accountants Act, 1949, Chartered Accountants Regulations, 1988 and under Code of Ethics to ensure Independence of Auditors***

3.4.1 Clause (10) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits acceptance of, what have been described as contingent fees, i.e., fees, which are either based on percentage of profits or otherwise dependent on the finding or the results of employment.

3.4.2 What distinguishes a profession from a business is that professional service is not rendered with the sole purpose of a profit motive. Personal gain is one but not the main or the only objective. Professional opinion, therefore, frowns upon methods where payment is made to depend on the basis of results. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the

advantage of his service or may adopt means which are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, the members are prohibited from charging or accepting any remuneration based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings.

3.4.3 Professional services should not be offered or rendered under an arrangement whereby no fee will be charged unless a specified finding or result is obtained or where the fee is otherwise contingent upon the findings or results of such services. However, fee should not be regarded as being contingent if fixed by a Court or other public authority.

3.4.4 The Council of the Institute has framed Regulation 192 which exempts members from the operation of this Clause in certain professional services. The said Regulation 192 is reproduced below:

**“192. Restriction on fees**

No chartered accountant in practice shall charge or offer to charge, accept or offer to accept, in respect of any professional work, fees which are based on a percentage of profits, or which are contingent upon the findings, or results of such work:

Provided that:

- (a) in the case of a receiver or a liquidator, the fees may be based on a percentage of the realisation or disbursement of the assets;
- (b) in the case of an auditor of a co-operative society, the fees may be based on a percentage of the paid up capital or the working capital or the gross or net income or profits; and
- (c) in the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of the property valued.”

3.4.5 Attention of the members is invited to the provisions of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 which provides that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he expresses his opinion on financial statements of any business or any enterprise in which he, his firm or a partner in his firm has a substantial interest, unless he discloses his interest also in his report.

3.4.6 If the opinion of auditors are to command respect and the confidence of the public, it is essential that they must disclose every factor which is likely to affect their independence. Since financial interest in the business can be one of the important factors, which may disturb independence, the clause provides that the existence of such an interest direct or indirect should be disclosed. This is intended to assure the public as regards the faith and confidences that could be reposed on the independent opinion expressed by the auditors.

3.4.7 The words “financial statements” used in this clause would cover both reports and certificates usually given after an examination of the accounts or the financial statement or any attest function under any statutory enactment or for purposes of income-tax assessments. This would not however, apply to cases where such statements are prepared by members in

### III.8 Auditing Pronouncements

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employment purely for the information of their respective employers in the normal course of their duties and not meant to be submitted to any outside authority.

3.4.8 Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires and should not place themselves in positions which would either compromise or jeopardise their independence.

3.4.9 A Member must take care to see that he does not get into situations where there could be a conflict of interest and duty. For example, where a Chartered Accountant is appointed the liquidator of a company, he should not himself audit the Statement of Account to be filed under Section 551 (1) of the Companies Act, 1956. The audit in such circumstances should be done by a Chartered Accountant other than the one who is the liquidator of the company. Attention of the members is drawn to the audit assignments where appointment is done by the Comptroller & Auditor General of India (C&AG), Reserve Bank of India (RBI) and such other authorities. In addition to ensuring independence during the assignment, it is also essential to avoid any situation in near future which may be interpreted as a threat to independence, as for example, he or any other partner of his firm should not accept any other assignment such as internal audit, system audit and management consultancy services within one year from the completion of audit assignment.

3.4.10 A Chartered Accountant in employment should not certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any chartered accountant in practice. This restriction would not however apply where the certification is permitted by any law, e.g. Section 228 (iv) of the Companies Act, 1956 and the Companies (Branch Audit Exemption) Rules made thereunder. The Council has decided that a chartered accountant should not by himself or in his firm name:-

- (i) accept the auditorship of a college, if he is working as a part-time lecturer in the college.
- (ii) accept the auditorship of a trust where his partner is either an employee or a trustee of the trust.

3.4.11 Many new areas of professional work have been added, e.g., Special Audit under the Statutes, Tax Audit, Concurrent Audit of Banks, Concurrent Audit of Borrowers of Financial institutions, Audit of non-corporate borrowers of banks and financial institutions, audit of stock exchange, brokers etc. The Council wishes to emphasize that the requirement of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 is equally applicable while performing all types of attest functions by the members.

3.4.12 Some of the situations which may arise in the applicability of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 are discussed below for the guidance of members:-

**1. *Where the member, his firm or his partner or his relative has substantial interest in the business or enterprise.***

The independence of mind is a fundamental concept of audit and/or expression of opinion on the financial statements in any form and, therefore, must always be maintained. Nothing can substitute for the essential and fundamental requirements of independence. Therefore, the Council's views are clarified in the following circumstances.

*(i) An enterprise/concern of which a member is either an owner or a partner*

The holding of interest in the business or enterprise by a member himself whether as sole-proprietor or partner in a firm, in the opinion of the Council, would affect his independence of mind in the performance of professional duties in conducting the audit and/or expressing an opinion on financial statements of such enterprise. Therefore, a member should not audit financial statements of such business or enterprise.

*(ii) Where the partner or relative of a member has substantial interest*

The holding of substantial interest by the partner or relative of the member in the business or enterprise of which the audit is to be carried out and opinion is to be expressed on the financial statement, may also affect the independence of mind of the member, in the opinion of Council, in the performance of professional duties. Therefore, the member may, for the same reasons as not to compromise his independence, desist from undertaking the audit of financial statements of such business or enterprise. However, where a member undertakes the audit of such business or enterprise, he should disclose such interest in his report while expressing his opinion on the financial statements of such business or enterprise.

**2. *Where the member or his partner or relative is a director or in the employment of an officer or an employee of the company***

Section 226 of the Companies Act, 1956 specifically prohibits a member from auditing the accounts of a company in which he is a director or in the employment of an officer or an employee of the company. Although the provisions of the aforesaid section are not specifically applicable in the context of audits performed under other statutes, e.g. tax audit, yet the underlying principle of independence of mind is equally applicable in those situations also. Therefore, the Council's views are clarified in the following situations.

*(i) Where a member is a director*

In cases where the member is a director of a company the financial statements of which are to be audited and/or opinion is to be expressed, he should not undertake such job and/or express opinion on the financial statements of that company.

*(ii) Where a partner or relative of the member is a director in the company who has a substantial interest.*

### III.10 Auditing Pronouncements

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In such cases for the reason as not to compromise with the independence of mind, the member may desist from undertaking the audit of financial statements and/or expression of opinion thereon. However, if a member feels that his independence is not affected and undertakes the audit of such company, he should disclose such interest in his report while expressing his opinion on the financial statements of such company.

The meaning of the words "relative" and "substantial interest" shall be the same as are contained in the Resolution passed by the Council in pursuance to Regulation 190A of Chartered Accountants Regulations, 1988 (Appendix 9 of 2002 edition).

3.4.13 An accountant is expected to be no less independent in the discharge of his duties as a tax consultant or as a financial adviser than as auditor. In fact, it is necessary that he should bear the same degree of integrity and independence of mind in all spheres of his work. Unless this is done, the accounts of companies audited by Chartered Accountants or statements made by them during the course of assessment proceedings would not be relied upon as correct by the authorities.

3.4.14. The Members are not permitted to write the books of accounts of their auditee clients.

3.4.15 A statutory auditor of a company cannot also be its internal auditor, as it will not be possible for him to give independent and objective report issued under sub-Section 4A of Section 227 of the Companies Act, 1956 read with the Companies (Auditors' Report) Order, 2003.

3.4.16 The Council has issued a Notification No.1-CA(37)/70 dated 23<sup>rd</sup> May, 1970 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if—

- I. he accepts appointment as Cost auditor of Company under Section 233B of the Companies Act, 1956 while he -
  - (a) is an auditor of the company appointed under Section 224 of the Companies Act; or
  - (b) is an officer or employee of the company; or
  - (c) is a partner, or is in the employment of an officer or employee of the company; or
  - (d) is a partner or is in the employment of the Company's auditor appointed under Section 224 of the Companies Act, 1956; or
  - (e) is indebted to the company for an amount exceeding one thousand rupees, or has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;

OR

- II. after his appointment as Cost Auditor, he becomes subject to any of the disabilities stated in items I (a) to (e) above and continues to function as a cost auditor thereafter.

3.4.17 The Council has issued a Notification No.1-CA(39)/70 dated 16<sup>th</sup> October, 1970 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as auditor of a company under Section 224 of the Companies Act, 1956, while he is an employee of the cost auditor of the Company appointed under Section 233B of the Companies Act, 1956.

3.4.18 The Council has issued a Notification No.1-CA(7)/60/2002 dated 8<sup>th</sup> March, 2002 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as statutory auditor of Public Sector Undertaking(s)/Government Company(ies)/Listed Company(ies) and other Public Company(ies) having turnover of Rs. 50 crores or more in a year and accepts any other work(s) or assignment(s) or service(s) in regard to the same Undertaking(s)/ Company(ies) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same Undertaking/company.

3.4.19 The Council has issued a Notification No.1-CA(7)/63/2002 dated 2<sup>nd</sup> August, 2002 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts appointment as auditor of a concern while he is indebted to the concern or has given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding Rs. 10,000/-.

3.4.20 To ensure that the professional independence of a member doing attest function does not appear to be jeopardized he should, as far as possible, take care to see that the professional fees for audit and other services received by the firm in which he is a partner, by him and his partners individually and by firm or firms in which he or his partner are partners from one or more clients or companies under the same management does not exceed 40% of the gross annual fees of the firm, firms and partners referred to above. 'Companies under the same management' here would refer to the definition of this expression as provided in section 370(1-B) of the Companies Act, 1956.

Provided that no such ceiling on the gross annual professional fees of a member would be applicable where such fees do not exceed two lakhs of rupees in respect of a member or firm including fees received by the member or firm for other services rendered through the medium of a different firm or firms in which such member or firm may be a partner or proprietor.

Provided further that no such ceiling on the gross annual professional fees of a member would be applicable in the case of audit of government companies, public undertakings, nationalized banks, public financial institutions or where appointments of auditors are made by the Government.

3.4.21 Members' attention is also drawn to Clauses (8) & (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949:

"A Member shall be deemed to be guilty of professional misconduct, if he:

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### III.12 Auditing Pronouncements

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- (8) accepts a position as auditor previously held by another chartered accountant or a restricted state auditor without first communicating with him in writing;
- (9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with."

3.4.22 Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949 emphasized the requirement of mandatory communication with the previous auditor in all types of audit viz., statutory audit, tax audit, internal audit, concurrent audit or any kind of audit and it is equally applicable to audits of both government and non-government entities.

3.4.23 Clause (9) of Part I of First Schedule to the Chartered Accountants Act, 1949 provided that an auditor of the company before accepting the appointment, should ascertain from the auditor whether the requirements of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with. Section 224 of the Companies Act, 1956 contains several provisions in the matter of appointment of auditors in different circumstances and situations whereas Section 225 laid down the procedure which must be followed whenever a company desires to change its auditor. Also that the validity of the appointment of an auditor is not challenged or objected to by shareholders or the retiring auditors at a later date, it has been made obligatory to ascertain from the company that the appropriate procedure in the matter of appointment has been faithfully followed. Independence of auditor is a concept to be addressed through its all the possible aspects and the message of Clause (8) & (9) is to ensure that an auditor should be conscious about this aspect from the very point of accepting the position of an auditor.

#### 4. CONCLUSION

4.1 The Council feels that there are adequate safeguards provided in the Companies Act, 1956 as well as in the Chartered Accountants Act, 1949. The Council is of the view that independence, being a state of the mind, is not necessarily affected by the fact of mere relationship any more than it should be existence if the relationship did not exist. In any case, lest there may be any feeling in the public mind that relationship would affect the independence of auditors, the Council suggests that where, due to near relationship of an auditor, with a Managing or a Whole-Time Director the independence of an auditor is likely to be jeopardized, he should use his good sense, and acting in the best traditions of the profession, refrain from accepting the appointment.

4.2 If the opinion of chartered accountant is to command respect and the confidence of the public, it is essential that they must ensure their independence to assure the public as regards the faith and confidence that could be reposed on them. The Chartered Accountant should ensure his independence in all assurance services including concurrent audit, tax audit and internal audit. The chartered accountant should make it certain that his independence is not jeopardized. Where he feels that his independence is jeopardized, he should refrain from accepting the assignment.

## GUIDANCE NOTE ON PROVISION FOR PROPOSED DIVIDEND\*

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1. This Statement summarises the Council's view regarding the responsibility of the auditor relating to the provision for and disclosure of proposed dividend and replaces all earlier statements on this subject.
2. The Council is aware of the fact, that a large number of companies do not provide for the proposed dividend but either carry forward the balance on the profit and loss account or transfer an amount to the General Reserve and charge the dividend to the profit and loss account or to the reserve when payment is made.
3. The Council is of the view that a proposed dividend does not represent a liability nor does it amount to a provision, pending the approval of the shareholders in General Meeting. Since the meeting to approve the accounts would take place after the Balance Sheet date, there could not be any liability in respect of the proposed dividend on the date of the Balance Sheet. The Council is of the opinion that merely because the form requires proposed dividend to be shown under "Current Liabilities and Provisions", it does not mean that in fact the proposal for the dividend becomes a liability or is necessarily a provision. The Council would draw attention to the forms of accounts laid down under the Insurance Act, 1938 and the Banking Regulation Act, 1949, in both of which it is not a requirement to show "proposed dividend" and it cannot be contended that merely because proposed dividend is not shown in the accounts, that the accounts of Insurance and Banking Companies do not disclose a 'true and fair' view.
4. Since, however, the form of Balance Sheet prescribed in Part 1 of Schedule VI requires "proposed dividends" to be shown under "Provisions", and since paragraph 3(xiv) of Part II of the same Schedule requires the "proposed dividends" to be disclosed, the Council is of the opinion that, though on correct accounting principles, the proposed dividend does not become a liability for reasons mentioned above, the attention of the shareholders would have to be drawn to the fact that no appropriation has been made for the proposed dividend, the amount in respect of which should be specified.
5. The Council, therefore, recommends that the fact that provision for proposed dividend has not been made should be disclosed by means of a note in the accounts and that the auditor should refer to the note in his report and make his report subject thereto.

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\* Published in CICA Newsletter, November, 1975, p.78.

## GUIDANCE NOTE ON AUDIT REPORTS AND CERTIFICATES FOR SPECIAL PURPOSES\*

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### 1. INTRODUCTION

1.1 Government authorities may under various statutes or notifications, require reports or certificates from auditors in support of statements or other information prepared by an enterprise. Reports or certificates on specific matters may also be required from auditors by an enterprise, for its own special purposes. These reports or certificates cater, to specific requirements of the individual users unlike a 'general purpose report' e.g., an auditor's report on financial statements which is intended for general use. An audit report or certificate for special purpose is one to which the format of general purpose audit report is not applicable.

1.2 This note is intended to provide guidance to members who may be called upon to give audit reports or certificates for special purposes (herein referred to as 'reporting auditors'). Reports on profit and/or financial forecasts and on tax audit do not fall within the scope of this Guidance Note.\*\*

### 2. SCOPE OF SPECIAL PURPOSE AUDIT REPORTS AND CERTIFICATES

2.1 Audit reports or certificates for special purposes may be issued in connection with:

- (a) financial statements which are prepared in addition to general purpose financial statements;
- (b) specified elements, accounts or items of a financial statement;
- (c) compliance with requirements of any agreement or statute or regulation;
- (d) financial information given in special purpose formats or schedules; or
- (e) compilation of statistics or ascertainment of basic figures e.g., for the purpose of fixing quotas or levies.

2.2 A reporting auditor should appreciate the difference between the terms 'certificate' and 'report'. A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and

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\* Issued in March, 1984

\*\*These subjects have been dealt with in separate publications of the Institute, viz. 'SAE 3400, "The Examination of Proposed Financial Information"' and "Guidance Note on *Tax Audit under Section 44AB of the Income Tax Act, 1961*".

includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

### **3. RESPONSIBILITY FOR PREPARATION OF SPECIAL PURPOSE STATEMENTS**

The primary responsibility for the contents of a special purpose statement rests with the enterprise and this would be evidenced by a suitable declaration or authentication by the management on the face of the statement.

### **4. SCOPE OF A REPORTING AUDITOR'S FUNCTION**

4.1 A reporting auditor should have a clear understanding of the scope and nature of the terms of his assignment. It is desirable for him to obtain the terms in writing to avoid any misunderstanding.

4.2 A reporting auditor is not an expert on purely technical matters and as such, when he is required to report on or certify such matters (e.g., composition or quality of a product) which are of paramount importance and constitute the very basis of the figures contained in the statement, he should state his limitations clearly in the report or certificate. At the same time, he should indicate the extent to which he has been able to exercise his own professional skill and judgement with regard to the matter being reported upon. For instance, he may state that, for the purpose of forming his opinion, he has relied upon a certificate from technical experts. He should, of course, satisfy himself about the technical qualifications of the expert, and subject the expert's certificate to a reasonable review.

### **5. CONTENTS OF REPORTS AND CERTIFICATES FOR SPECIAL PURPOSES**

5.1 In many cases, a reporting auditor can choose the form and contents of his report or certificate. In other cases, the form and contents of the report or certificate are specified by statute or notification and cannot be changed.

5.2 Where a reporting auditor is free to draft his report or certificate, he should consider the following:

- (a) Specific elements, accounts or items covered by the report or certificate should be clearly identified and indicated.
- (b) The report or certificate should indicate the manner in which the audit was conducted, e.g., by the application of generally accepted auditing practices, or any other specific tests.
- (c) If the report or certificate is subject to any limitations in scope, such limitations should be clearly mentioned.
- (d) Assumptions on which the special purpose statement is based should be clearly indicated if they are fundamental to the appreciation of the statement.

### III.16 Auditing Pronouncements

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- (e) Reference to the information and explanations obtained should be included in the report or certificate. In certain cases apart from a general reference to information and explanations obtained, a reporting auditor may also find it necessary to refer in his report or certificate to specific information or explanations on which he has relied.
- (f) The title of the report or certificate should clearly indicate its nature, i.e., whether it is a report or a certificate. Similarly, the language should be unambiguous, i.e., it should clearly bring out whether the reporting auditor is expressing an opinion (as in the case of a report) or whether he is only confirming the accuracy of certain facts (as in the case of a certificate). For this, the choice of appropriate words and phrases is important.
- (g) If the special purpose statement is based on general purpose financial statements, the report or certificate should contain a reference to such statements. However, the report or certificate should not contain a reference to any other statement unless the same is attached therewith. It should be clearly indicated whether or not the statutory audit of the general purpose financial statements has been completed and also, whether such audit has been conducted by the reporting auditor or by another auditor. In case the general purpose financial statements have been audited by another auditor, the reporting auditor should specify the extent to which he has relied on them. He may communicate with the statutory auditor for securing his cooperation and in appropriate circumstances, discuss relevant matters with him, if possible.
- (h) Where a report requires the interpretation of a statute, the reporting auditor should clearly indicate the fact that he is merely expressing his opinion in the matter. He should take sufficient care to ensure that in respect of matters which are capable of more than one interpretation, his report is not misconstrued as representing a settled legal position.
- (i) An audit report or certificate should ordinarily be a self-contained document. It should not confine itself to a mere reference to another report or certificate issued by the reporting auditor but should include all relevant information contained in such report or certificate.
- (j) The reporting auditor should clearly indicate in his report or certificate, the extent of responsibility which he assumes. Where the statement on which he is required to give his report or certificate, includes some information which has not been audited, he should clearly indicate in his report or certificate the particulars of such information.

5.3 In certain cases, the form and/or contents of the report or certificate, as prescribed by a statute or a notification, may not be appropriate or adequate. In such situations, the reporting auditor may consider modifying the report or certificate on the basis of the suggestions made in para 5.2 supra, to the extent applicable. In case this is not possible, he should clearly indicate the limitations in his report or certificate itself.

## 6. EXTENT OF RELIANCE ON GENERAL PURPOSE AUDIT REPORT

6.1 Where a special purpose engagement is undertaken after the statutory audit has been completed, a reporting auditor should invariably review the statutory audit report to ascertain whether there are any matters which have a bearing on his report or certificate.

6.2 In cases, where a reporting auditor is required to report or certify certain specific matters arising from the financial statements taken as a whole, he should not normally issue his report or certificate until the statutory audit has been completed. For instance, a reporting auditor may be required to state whether, in the case of an Indian branch of a foreign company, the profit shown in the accounts represents the remittable surplus of the branch, or he may be asked to report on the computation of 'gross profit' for the purpose of bonus under the Payment of Bonus Act, 1965. In such cases, it would normally not be proper for him to give his report or certificate until the statutory audit has been completed, since he would not really be in a position to state whether the profit shown in the accounts itself has been properly computed.

6.3 Where an audit report or certificate is required before the statutory audit is completed, a reporting auditor should clearly state in his audit report or certificate that he is reporting on or certifying specific matters arising out of the financial statements of the enterprise, the statutory audit of which has not been completed.

6.4 Where the reporting auditor prepares his report or certificate on the basis of duly audited general purpose financial statements he may take the following precautions:

- (i) He may clearly state in his report or certificate that the figures from the audited general purpose financial statements have been used and relied upon.
- (ii) He may include in his report or certificate a statement showing the reconciliation between the figures in the general purpose financial statements and the figures appearing in his report or certificate.

## 7. LIMITED REVIEW REPORT

Section 7, "Limited Review Report" was withdrawn pursuant to issuance of the Guidance Note on Engagements to Review Financial Statements. However, the Guidance Note on Engagements to Review Financial Statements has also been withdrawn with the issuance of SRE 2400\*\*\*, "Engagements to Review Financial Statements".

## 8. REPORTS AND CERTIFICATES ON SPECIFIED ACCOUNTS OR ITEMS OF FINANCIAL STATEMENTS

8.1 The test of materiality which a reporting auditor uses in connection with special purpose reports may be different, depending upon the circumstances, from the test he would use in connection with a general purpose report. For example, where he is required to express an opinion on specified accounts or items of financial statements, he may judge the materiality of an item solely in relation to such individual accounts or items rather than to the aggregate thereof or to the financial statements as a whole. A reporting auditor's examination of certain records for an audit report or certificate for special purpose may also be more intensive than the examination of the same records by the statutory auditor for the purpose of expressing an opinion on the general purpose financial statements as a whole.

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\*\*\* Hitherto known as AAS 33, "Engagements to Review Financial Statements".

### III.18 Auditing Pronouncements

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8.2 Certain accounts or items of financial statements are inter-related, e.g., sales and debtors, purchases and creditors, fixed assets and depreciation, etc. Therefore, where reporting auditor is required to examine and report upon or certify a specified account or items of financial statements, he may also need to examine the related accounts or items to discover the inconsistencies, if any, between these inter-related accounts or items.

#### 9. OTHER ENGAGEMENTS

Section 9, "Other Engagements" has been withdrawn pursuant to the issuance of the Guidance Note on Members' Duties regarding Engagements involving Compilation of Financial Statements. However, the Guidance Note on Member's Duties regarding Engagements involving Compilation of Financial Statements has also been withdrawn with the issuance of SRS 4410<sup>@</sup>, "Engagements to Compile Financial Information".

#### 10. COMMUNICATION OF REPORT OR CERTIFICATE

10.1 The reporting auditor may address his report or certificate to the client or to the public authority or person requiring it, as the case may be. In appropriate circumstances, a certificate may be issued without reference to any particular person or authority by using the words, 'To Whomsoever It May Concern'.

10.2 The report or certificate should normally be issued to the client who should be responsible for forwarding the same to the concerned authority, where so required.

#### 11. COMMUNICATION WITH THE PREVIOUS REPORTING AUDITOR

It would be a healthy tradition if the practice of communicating with the member who had done the work previously is followed in every case where a member is required to give a report or certificate for a special purpose.

#### 12. ILLUSTRATIONS

The appendices to this Note give certain illustrations of audit reports and certificates for special purposes. **Appendix I** contains certain statutory certificates while Appendix II comprises of specimen certificates of non-statutory nature. It may be noted that there are a large number of other certificates-statutory and non-statutory-which a Chartered Accountant may be called upon to issue under specific circumstances.

#### Appendix-I

##### Illustrations of Statutory Audit Reports and Certificates for Special Purposes

*(1) Auditor's certificate in the application for consent to the issue of bonus shares made to the Controller of Capital Issues<sup>1</sup>:*

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<sup>@</sup> Hitherto known as AAS 31, "Engagements to Compile Financial Information".

<sup>1</sup> Part E of Schedule B to the Capital Issues (Application for Consent) Rules, 1966, Notification No. G.S.R. 600 dated 29<sup>th</sup> March 1966, Government of India, Ministry of Finance.

"We have verified the information furnished by the company for issue of bonus shares and find the same as correct. We also certify that we have received all the information required by us for the verification.

We hereby certify that the proposal contained in the application for the issue of bonus shares meets all the requirements of the bonus issue guidelines, including the guidelines contained in paragraphs 8, 9, 11 and 13 in force issued by the Government in this regard according to the information furnished to us and to the best of our knowledge."

*(2) Auditors' certificate in the application form<sup>2</sup> for issue of securities other than bonus shares under the Capital Issues Control Act, 1947.*

"We have verified the information furnished in the above application of the company for issue of fresh capital and find the same as correct. We also certify that we have received all the information required by us for the verification.

We hereby certify that the requirements of clause 5 of the Capital Issues (Exemption) Order, 1969, have been fully met by the company for the issue of acknowledgment/consent by the Controller of Capital Issues according to the information furnished to us and to the best of our knowledge."

*(3) Chartered Accountant's Certificate<sup>3</sup> on Exports*

Ref No.....

Date .....

Place .....

#### Chartered Accountant's Certificate

"This is to certify that we have checked and verified the above particulars of exports from the books / documents of M/s.....and found the same to be correct."

(Signature of the Chartered Accountant)

Official Stamp

Full Address.....

Regn. No.....

*(4) Chartered Accountant's certificate<sup>4</sup> on certain matters in the application for grant/renewal of 'Export House' certificate under Import- Export Policy 1983-84*

#### Certificate of the Chartered Accountant

"We.....(name and address of the Chartered Accountant) hereby certify that we have checked and verified the above particulars of exports from the books / documents of

<sup>2</sup> Part G of Schedule A to the Capital Issues (Application for Consent) Rules, 1966, Notification No. G.S.R. 600 dated 29<sup>th</sup> March 1966, Government of India, Ministry of Finance.

<sup>3</sup> Annexure XI of Appendix 10 to The Hand Book of Import-Export Procedures, 1983-84, Vol. II, Government of India, Ministry of Commerce, page 162.

<sup>4</sup> Annexure XX of Appendix 10 to the Hand Book of Import-Export Procedures, 1983-84, Vol. II, Government of India, Ministry of Finance, page 171.

### III.20 Auditing Pronouncements

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M/s.....and found the same to be correct. We also certify that the exports mentioned in this statement, excluding those exports which were made as associates of the STC/MMTC are direct exports of M/s. .... and the export documents viz, export order/contract, bank certificate and invoice were in the name of M/s. .... We have verified that each export invoice is properly supported by a purchase voucher."

Signature of the Chartered Accountant  
Official Stamp

Full Address .....  
Registration No .....  
Dated .....

*(5) Chartered Accountant's Certificate<sup>5</sup> on the statement showing consumption of imported raw materials, Components and Consumables under Import-Export Policy 1983-84.*

1. "I/We have verified that the applicant unit has duly furnished to the D.G.T.D, Department of Electronics, Textile Commissioner or other sponsoring authorities concerned, its production returns for the year 1982-83 and other prescribed returns/statements for the same year, as it was required to furnish under the provisions of Imports and Exports Control Rules, Industrial (Development and Regulation) Act, Textile Control Order, etc.
2. I/We do hereby certify that consumption as certified in the statement has been verified from the books maintained by M/s. .... and found the same as correct. I/We have also put my/our office seal and signature on the books from which the information has been verified.
3. I/We also certify that the applicant unit has been maintaining proper account of consumption in the prescribed form as indicated in the Hand Book of Import-Export Procedures, 1983-84.
4. I am not a partner, a Director or an employee of the applicant firm or its associates.
5. I have been duly appointed for the purpose by the Board of Directors of the Company or management as the case may be (In the case of Chartered Accountants/Cost Accountant)"

Signature and Seal of Chartered Accountant  
Name of the Signatory

Full address.....  
Date .....  
(Seal)

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<sup>5</sup> Appendix 11 of the Import and Export Policy, 1983-84, Vol. I, Government of India, Ministry of Finance, page 182.

*(6) Chartered Accountant's certificate<sup>6</sup> regarding certain matters in the Application for Grant of Export Performance Certificate under Import-Export Policy 1983-84.*

"I/We do hereby certify that the information given in this statement has been verified from the books maintained by M/s .....,and found the same as correct. I/We have also put my/our office seal and signature on the books from which the information has been verified.

I/We am/are neither a partner, a Director nor an employee of the applicant or its associates."

Place

Date

Signature and seal of Chartered Accountant  
Name of the signatory

Full address .....

Membership No .....

(Seal)

Residential Address .....

## Appendix-II

### Illustration of non-statutory audit reports and certificates for special purposes

*(1) Chartered Accountant's certificate<sup>7</sup> regarding employers' bonus computation*

"We have reviewed the figure in the above computation, in comparison with the books and records of X Company Limited, produced to us, the audit of which has already been completed by us and/or another firm of chartered accountants and report that, subject to the notes given on the face of computation, in our opinion, and to the best of our knowledge and belief and according to the information and explanations given to us, the above computation is in due accordance therewith and has been made on a basis reasonably consistent with the provisions of the Payment of Bonus Act, 1965."

*(2) Auditor's certificate<sup>8</sup> pursuant to Companies (Acceptance of Deposits) Rules, 1975.*

"We have examined the books of account and records maintained by ..... Company Ltd. in respect of the particulars furnished in the Return of Deposits as on 31st March 19..... and certify that to the best of our knowledge and according to the information and explanations given to us and as shown by the records examined by us, the figures of deposits and interest rates under Parts A, B and C of the Return are correct.

<sup>6</sup> Appendix 13 of the Import & Export Policy, 1983-84, Vol. I, Government of India, Ministry of Finance, page 185.

<sup>7</sup> The Payment of Bonus Act, 1965 – An Accountant's Study, The Institute of Chartered Accountants of India, page 7.

<sup>8</sup> A Note on the Companies (Acceptance of Deposits) Rules, 1975, The Institute of Chartered Accountants of India, page 77.

### III.22 Auditing Pronouncements

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We further certify the correctness of the particulars of the paid up capital and free reserves, etc. given in the Manager's Certificate."

*(3) Chartered Accountant's Report on the basis of a limited review of interim financial statements<sup>@@</sup>.*

*(4) Accountants' Report on Unaudited Statements<sup>@@@</sup>*

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<sup>@@</sup> Refer to SRE 2400, "Engagements to Review Financial Statements".

<sup>@@@</sup> Refer to SRS 4410, "Engagements to Compile Financial Information".

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## GUIDANCE NOTE ON AUDIT OF ABRIDGED FINANCIAL STATEMENTS\*

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The following is the text of the Guidance Note on Audit of Abridged Financial Statements, issued by the Auditing Practices Committee<sup>1</sup> of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the 'Preface to the Statements on Standard Auditing Practices'<sup>2</sup> issued by the Institute.

### INTRODUCTION

1. Sub-section (1) of section 219 of the Companies Act, 1956 requires every company to send a copy of its Balance Sheet, Profit and Loss Account and other documents attached or annexed to the Balance Sheet to its members and other persons specified therein. The Companies (Amendment) Act, 1988 has inserted a new proviso (b)(iv) to sub-section (1) which provides that a company listed on a recognised stock exchange may, instead of sending a copy of the documents as aforesaid, send a statement containing the salient features thereof in the prescribed form, subject to complying with certain conditions. The purpose of this Guidance Note is to provide guidance to members on issues relating to audit of such a statement.

### LEGAL REQUIREMENTS

2. Sub-section (1) of section 219 of the Companies Act, 1956 provides:

"(1) A copy of every Balance Sheet (including the Profit and Loss Account, the auditors' report and every other document required by law to be annexed or attached, as the case may be, to the Balance Sheet) which is to be laid before a company in general meeting shall, not less than twenty-one days before the date of the meeting, be sent to every member of the company, to every trustee for the holders of any debentures issued by the company, whether such member or trustee is or is not entitled to have notices of general meeting of the company sent to him, and to all persons other than such members or trustees, being persons so entitled;

Provided that –

- (a) in the case of a company not having a share capital, this sub-section shall not require the sending of a copy of the documents aforesaid to a member, or holder of debentures, of

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\* Issued in August, 1990.

<sup>1</sup> Now known as the Auditing and Assurance Standards Board.

<sup>2</sup> The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.

### III.24 Auditing Pronouncements

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company who is not entitled to have notices of general meeting of the company sent to him;

- (b) this sub-section shall not require a copy of the documents aforesaid to be sent –
- (i) to a member, or holder of debentures, of the company, who is not entitled to have notices of general meetings of the company sent to him and of whose address the company is unaware;
  - (ii) to more than one of the joint holders of any shares or debentures none of whom is entitled to have such notices sent to him;
  - (iii) in the case of joint holders of any shares or debentures some of whom are and some of whom are not entitled to have such notices sent to them, to those who are not so entitled;
  - (iv) in the case of a company whose shares are listed on a recognised stock exchange, if the copies of the documents aforesaid are made available for inspection at its registered office during working hours for a period of twenty-one days before the date of the meeting and a statement containing the salient features of such documents in the prescribed form or copies of the documents aforesaid, as the company may deem fit, is sent to every member of the company and to every trustee for the holders of any debentures issued by the company not less than twenty-one days before the date of the meeting."

It can be seen that proviso (b)(iv) gives an option to a company whose shares are listed on a recognised stock exchange to send either (a) a copy of the balance sheet and other documents listed in sub-section (1), or (b) a statement containing the salient features of those documents in the prescribed form. In the latter case, however, copies of the documents listed in sub-section (1) (i.e., Balance Sheet, Profit and Loss Account, auditors' report and other documents required by law to be annexed or attached to the balance sheet) have to be made available for inspection at the registered office of the company during working hours for a period of twenty-one days before the date of the meeting.

3. The Central Government has prescribed the form and content of the statement to be sent in pursuance of proviso (b)(iv) to section 219(1)<sup>3</sup>. Accordingly, such a statement should contain–

- (a) an abridged Balance Sheet in the prescribed form;
- (b) an abridged Profit and Loss Account in the prescribed form;
- (c) the auditors' report in full; and
- (d) the report of the board of directors in full, except that the particulars of employees (to be included in the board's report pursuant to the requirements of sub-section (2A) of section 217 of the Act) need not be given.

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<sup>3</sup> Form No. 23AB, prescribed by Notification No. GSR 449(E) dated April 17, 1989, Department of Company Affairs, Ministry of Industry, Government of India. The form is reproduced in Appendix A to this Guidance Note.

The documents at (a) and (b) are collectively referred to in this Guidance Note as 'abridged financial statements'. The terms 'Balance Sheet' and 'Profit and Loss Account' used in this guidance note refer to those statements prepared in accordance with the requirements of Schedule VI to the Companies Act, 1956.

4. It may be emphasised that the format of abridged financial statements, as prescribed by the Central Government, represents the minimum disclosure requirements. Therefore, if in the circumstances of a particular case, disclosure of certain information is considered necessary or desirable to enable the readers to appreciate properly the financial position or the working results, it is recommended that the company should disclose such information in its abridged financial statements even in the absence of a specific requirement to do so.

#### FORM AND CONTENT OF ABRIDGED BALANCE SHEET

5. The abridged Balance Sheet is required to be prepared in vertical form and has to disclose the various sources of funds and applications thereof.

6. The sources of funds are to be broadly classified into shareholders' funds and loan funds. Shareholders' funds comprise (a) capital (equity and preference capital to be disclosed separately) and (b) reserves and surplus (classified into capital reserve, revenue reserve, revaluation reserve and surplus in the profit and loss account). Loan funds comprise debentures, public deposits, secured loans (other than debentures) and unsecured loans. It may be noted that deferred payment liabilities would also be included in loan funds.

7. With regard to the disclosure of reserves, the following extracts from Part III of Schedule VI to the Companies Act, 1956, setting out the definitions of the terms *reserve*, *capital reserve* and *revenue reserve*, may be noted.

"(1) For the purposes of Parts I and II of this Schedule, unless the context otherwise requires:

- (a) the expression "provision" shall, subject to sub clause (2) of this clause, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;
- (b) the expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for any known liability;
- (c) the expression "capital reserve" shall not include any amount regarded as free for distribution through the Profit and Loss Account; and the expression "revenue reserve" shall mean any reserve other than a capital reserve;

and in this sub-clause, the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where –

- (a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

### III.26 Auditing Pronouncements

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(b) any amount retained by way of providing for any known liability; is in excess of the amount which, in the opinion of the directors, is reasonably necessary for the purpose, the access shall be treated for the purposes of this Schedule as a reserve and not as a provision."

8. The disclosure of reserves in the abridged Balance Sheet is somewhat different from that in the case of the Balance Sheet. For example, Capital Redemption Reserve is required to be shown separately in the Balance Sheet. In the abridged balance sheet, however, separate disclosure of capital redemption reserve is not required. In this regard, the following recommendations are made:

(a) Capital Reserves, Capital Redemption Reserve and Share Premium Account, as appearing in the balance sheet, may be included under the head 'Capital Reserves' in the abridged Balance Sheet.

(b) Revenue reserves are required to be disclosed separately in the abridged balance sheet. Revenue reserves, by definition, are available for distribution as dividend under the provisions of the Companies Act, 1956. However, investment allowance reserve, though a revenue reserve within the meaning of the Companies Act, cannot be distributed before the period specified in this behalf in the Income-tax Act, 1961, without foregoing the deduction claimed in respect thereof. Therefore, for a proper appreciation of the nature of various revenue reserves, it is suggested that investment allowance reserve, if material should be shown separately from other revenue reserves.

9. The application of funds comprise fixed assets, investments, current assets, loans and advances less current liabilities and provisions, miscellaneous expenditure to the extent not written off or adjusted, and the debit balance of profit and loss account. Investments are, to be classified into those in government securities, in subsidiary companies (quoted and unquoted investments to be shown separately) and others (quoted and unquoted investments to be shown separately). Current assets are to be classified into inventories, sundry debtors, cash and bank balances, and other current assets. Loans and advances to subsidiaries and to others are to be shown separately. Current liabilities have to be shown separately from provisions. The debit balance of profit and loss account should be shown after deduction of the uncommitted reserves, if any.

10. It is required that where fixed assets are revalued, the amount of revaluation should be shown separately for the first five years subsequent to the date of revaluation. This requirement is similar to that applicable in the case of disclosure of fixed assets in the balance sheet. Thus, a company which has revalued its assets will have to show the revalued amounts in place of the original cost in the abridged balance sheet. For the first five years subsequent to the date of revaluation, the amount of increase or decrease in the value of assets consequent to the revaluation will also have to be shown.

11. The market value of quoted investments has to be stated, both for the current year as also for the previous year.

**FORM AND CONTENT OF ABRIDGED PROFIT AND LOSS ACCOUNT**

12. The form of abridged profit and loss account requires the disclosure of income, expenditure, profit/loss before tax, provision for taxation, profit/loss after tax proposed dividend (separately in respect of preference shares and equity shares) and transfer to reserves/surplus.

13. Under the head 'income', details of sales/services rendered have to be given in the form prescribed in this behalf. Incomes in the form of dividend and in the form of interest have to be shown separately. Any other income, which does not fall within the sub-heads of 'sales/services rendered', 'dividend' and 'interest', has to be shown under the head 'other income'. In this regard, it is provided that any item which constitutes 20% or more of the total income should be shown separately in the abridged profit and loss account.

14. Under the head 'expenditure', the following details are required to be given: cost of goods consumed/sold (opening stock, purchases and closing stock to be shown separately); manufacturing expenses; selling expenses; salaries, wages and other employee benefits; managerial remuneration; interest; depreciation; auditor's remuneration; and provisions for (i) doubtful debts and (ii) other contingencies (to be specified). Those items of expenditure which do not fall in any of the above categories are to be shown under the head 'any other expenses'. As in the case of income, it is required that any item of expenditure which constitutes 20% or more of the total expenditure (including provisions) should be shown separately. The term 'managerial remuneration', for purposes of disclosure in the abridged profit and loss account, may be construed as having the same meaning as is assigned thereto in the Explanation to section 198 of the Companies Act, 1956. It may be mentioned that Schedule VI also requires a separate disclosure of managerial remuneration under section 198 paid or payable during the financial year'.

15. It may be noted that disclosure is required in the abridged profit and loss account of 'manufacturing expenses' and 'selling expenses'. The requirements of Part II of Schedule VI regarding the information to be disclosed in the profit and loss account do not envisage disclosure under these categories and follow a somewhat different classification of expenses. For example, Schedule VI requires disclosure of the total expenditure on rent, irrespective of whether the rent is paid in respect of factory premises or retail outlets. In the abridged profit and loss account, on the other hand, the rent on factory premises would be included under the head 'manufacturing expenses' whereas the rent in respect of retail outlets would form a part of 'selling expenses'. Thus, some of the items appearing in the profit and loss account may require analysis and re-classification for the purpose of inclusion under the heads 'manufacturing expenses' and 'selling expenses'. In this context, the term 'manufacturing expenses' may be construed as referring to direct production costs and production overheads other than those which are required to be disclosed separately in the abridged profit and loss account. Similarly, selling expenses may include all direct and indirect expenses on selling and distribution other than those which are required to be disclosed separately in the abridged

profit and loss account. The re-classification of the relevant items, as stated above, should be done on a reasonable basis, considering in particular the materiality of the items involved.

#### **OTHER REQUIREMENTS REGARDING ABRIDGED FINANCIAL STATEMENTS**

16. In the abridged financial statements, figures have to be given for the current year as well as for the previous year.

17. The total amount of contingent liabilities and that of capital commitments has to be shown separately, as a note to the abridged balance sheet.

18. The amount, if material, by which any item shown in the profit and loss account is affected due to any change in the basis of accounting, has to be disclosed separately. It is also required that where no provision is made for depreciation, the fact that no provision has been made should be stated along with the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act. These requirements are similar to those applicable in the case of the profit and loss account.

19. The instructions for preparation of abridged financial statements clearly specify that the amounts to be shown in the abridged statements should be the same as shown in the corresponding aggregated heads in the accounts as per Schedule VI or as near thereto as possible. It is also required that all notes forming part of the accounts as per Schedule VI to which specific attention has been drawn by the auditors or which form a subject matter of a qualification by the auditors should be reproduced. Similarly, any note forming part of the accounts as per Schedule VI which is in the nature of any explanation regarding compliance with any law should be reproduced.

20. Since all the notes forming part of the annual accounts as per Schedule VI are not required to be given in the abridged financial statements, a problem about their numbering may arise. To illustrate, suppose the abridged financial statements contain five notes, numbered sequentially from 1 to 5. These notes may have been numbered in the annual accounts as per Schedule VI as notes number 3, 4, 11, 16 and 21. The different numbering of the notes would make it difficult for a reader to relate the auditor's observations with reference to a specific note as contained in his report on annual accounts, with the notes appearing in the abridged financial statements. To overcome this difficulty, it is suggested that while giving a note on abridged financial statements, wherever necessary, its number in the annual accounts should also be specified.

#### **AUTHENTICATION OF ABRIDGED FINANCIAL STATEMENTS**

21. The abridged balance sheet and the abridged profit and loss account are required to be authenticated in the same manner as the balance sheet and profit and loss account are required to be authenticated.

## AUDIT OF ABRIDGED FINANCIAL STATEMENTS

22. Although the Companies Act, 1956 does not specifically require the abridged financial statements to be audited, it is a healthy practice to get these audited by statutory auditors. The audit of abridged financial statements assures the readers that the relevant information is properly disclosed in such statements and thus lends a greater degree of credibility to them.

23. It is recommended that where an auditor carries out an audit of the abridged financial statements, he should examine whether the requirements relating to preparation of such statements as laid down in the relevant notification have been duly complied with. In case the audit report on abridged financial statements is issued on a date subsequent to the issuance of the audit report on annual accounts as per Schedule VI, the auditor's responsibility in relation to event occurring after the balance sheet date is limited to the events occurring up to the date of his report on the annual accounts.

24. If, based on his examination as aforesaid, the auditor is satisfied that the abridged financial statements are proper in all respects, he should issue an unqualified audit report. An example of an unqualified audit report on the abridged financial statements of a company is given in Appendix B to this Guidance Note.

25. Where the auditor has certain reservations about the abridged financial statements, e.g., he is of the opinion that a material piece of information has not been disclosed in the abridged financial statements or has been disclosed in an inappropriate manner, he should express a qualified opinion or an adverse opinion, as appropriate. In this regard, he should bear in mind the relevant requirements of the *Statement on Qualifications in Auditor's Report*<sup>4</sup> issued by the Institute. An example of a qualified audit report on the abridged financial statements of a company is given in Appendix C to this Guidance Note.

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<sup>4</sup> The Council, at its 269<sup>th</sup> meeting held on July 18-20, 2007, decided to withdraw the Statement on Qualifications in Auditor's Report except paragraphs 2.1 to 2.30 dealing with reporting under section 227(1A) of the Companies Act, 1956 considering the fact that SA 700 implicitly covers the principles involved in issuing other than unqualified reports as well as examples of situations that may give rise to other than unqualified opinion and suggested working therefor. SA 700 and the Statement on Qualification in Auditor's Report are published in Volume I of the Handbook of Auditing Pronouncements – Compendium of Statements and Standards (edn. 2007).

(Ref. Para 3)  
**FORM NO. 23AB<sup>5</sup>**  
 (See Rule 7A)

**Statement Containing Salient Features of Balance Sheet  
 and Profit and Loss Account etc.  
 As per Section 219(1)(b)(iv)**

**FORM OF ABRIDGED BALANCE SHEET**

Name of the company .....

Abridged Balance Sheet as at .....

Particulars	<i>Figures as at the end of</i>	
	Current Financial Year	Previous Financial Year
<hr/>		

**I. Sources of Funds**

(1) Shareholders' funds

(a) Capital

(i) Equity

(ii) Preference

(b) Reserves and surplus

(i) Capital reserve

(ii) Revenue reserve

(iii) Revaluation reserve

(iv) Surplus in Profit and Loss Account

(2) Loan funds

(a) Debentures

(b) Public deposits

(c) Secured loans (other than debentures)

(d) Unsecured loans

Total of (1) and (2)

<sup>5</sup> Prescribed by Notification No. GSR 449(E) dated April 17,1989, Department of Company Affairs, Ministry of Industry, Government of India.

**II. Applications of funds**

## (1) Fixed assets

(a) Net block (original cost less depreciation)

(b) Capital work-in-progress

## (2) Investments

(a) Government securities

(b) Investment in subsidiary companies

(a) Quoted

(b) Unquoted

(c) Others

(a) Quoted

(b) Unquoted

## (3) (i) Current assets, loans and advances

(a) Inventories

(b) Sundry debtors

(c) Cash and bank balances

(d) Other current assets

(e) Loans and advances

(i) To Subsidiary companies

(ii) To others

Less

## (ii) Current liabilities and provisions

(a) Liabilities

(b) Provisions

Net current assets (i-ii)

## (4) Miscellaneous expenditure to the extent not written off or adjusted

## (5) Profit and Loss Account

Total of (1) to (5)

	_____	_____
	_____	_____

**Abridged Profit and Loss Account For the year ending —**

<i>Particulars</i>	<i>Figures for the current year</i>	<i>Figures for the previous year</i>
<b>I. Income</b>		
Sales/Services rendered (Details to be given separately as per Annexure)		
Dividend		
Interest		
Other income (See Note 5)		
Total		
<b>II. Expenditure</b>		
Cost of goods consumed/sold		
(i) Opening stock		
(ii) Purchases		
Less Closing stock		
Manufacturing expenses		
Selling expenses		
Salaries, wages and other employee benefits		
Managerial remuneration		
Interest		
Depreciation		
Auditor's remuneration		
Provisions for –		
(i) doubtful debts; and		
(ii) other contingencies (to be specified)		
Any other expenses (See Note 5)		
Total		
<b>III. Profit/loss before Tax (I - II)</b>		
<b>IV. Provision for taxation</b>		
<b>V. Profit/loss after tax</b>		
<b>VI. Proposed dividend</b>		
- Preference shares		
- Equity shares		
<b>VII. Transfer to reserves/surplus</b>		

**Notes to the Abridged Balance Sheet and the Abridged Profit and Loss Account**

1. The amounts to be shown here should be the same as shown in the corresponding aggregated heads in the accounts as per Schedule VI or as near thereto as possible.
2. The total amount of contingent liabilities and that of capital commitments should be shown separately.
3. All notes forming part of the Accounts as per Schedule VI to which specific attention has been drawn by the auditors or which form a subject matter of a qualification by the auditor should be reproduced.
4. If fixed assets are revalued, the amount of revaluation to be shown separately for the first five years subsequent to the date of revaluation.
5. Any item which constitutes 20% or more of the total income or expenditure (including provisions) should be shown separately.
6. Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting should be disclosed separately.
7. If no provision is made for depreciation, the fact that no provision has been made shall be stated along with the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act.
8. Market value of Quoted Investments (both for current year as also previous year) be mentioned.
9. Any note forming part of the Accounts as per Schedule VI which is in the nature of any explanation regarding compliance with any law should be reproduced.

The above stated salient features of Balance Sheet and Profit and Loss Account should be authenticated in the same manner as the Main Accounts are to be authenticated.

**Auditor's Report**

Should be given in full.

**Directors' Report**

Should be given in full except the information about employees under section 217 (2A).

(Signed by Directors/Secretary)  
in the manner prescribed in  
section 215(1)

**Annexure**

**Salient Features of Additional Information  
on the Profit and Loss Account for the Year Ended \_\_\_\_\_**

		Figures for the current year Rs.'000		Figures for the Previous year Rs.'000	
<i>Sales</i>	Units	Quantity	Rs. ( '000)	Quantity	Rs. ( '000)
Class of Goods					

**Appendix B**

*(Ref. Para 24)*  
**Specimen Auditor's Report On Abridged Financial Statements  
(Unqualified Opinion)**

To the members of \_\_\_\_\_ Limited,

We have examined the abridged balance sheet of \_\_\_\_\_ Limited as at \_\_\_\_\_ and the abridged profit and loss account for the year ended on that date, together with the notes thereon. These abridged financial statements have been prepared by the company pursuant to Rule 7A of the Companies (Central Government's) General Rules and Forms, 1956 and are based on the accounts of the company for the year ended \_\_\_\_\_ prepared in accordance with Schedule VI to the Companies Act, 1956 and covered by our report of even date to the members of the company which report is attached.

For \_\_\_\_\_  
Chartered Accountants  
Partner

Dated :  
Place :

**Appendix C**

*(Ref. Para 25)*  
**Specimen Auditor's Report on Abridged Financial Statement  
(Qualified Opinion)**

To the members of \_\_\_\_\_ Limited

We have examined the abridged balance sheet of \_\_\_\_\_ Limited as at \_\_\_\_\_ and the abridged profit and loss account for the year ended on that date, together with the notes thereon. Contrary to the requirements of Rule 7A of the Companies (Central Government's) General Rules and Forms, 1956, these abridged financial statements do not include notes nos. \_\_\_\_\_ (reproduced below) which form subject matters of qualifications in our report on the accounts prepared by the company in accordance with Schedule VI.

(Here, reproduce the notes referred to above.)

Subject to the above, these abridged financial statements have been prepared by the company pursuant to Rule 7A aforesaid and are based on the accounts of the company for the year ended \_\_\_\_\_ prepared in accordance with Schedule IV to the Companies Act, 1956 and covered by our report of even date to the members of the company which report is attached.

For \_\_\_\_\_  
Chartered Accountants  
Partner

Dated :  
Place :

## GUIDANCE NOTE ON AUDIT OF INVENTORIES\*

The following is the text of the Guidance Note on *Audit of Inventories*, issued by the Auditing Practices Committee (APC)\*\* of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)<sup>1</sup> issued by the Institute.

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices<sup>2</sup>" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Inventories, Chapter 5 of the *Statement on Auditing Practices*, titled "Inventories", shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.<sup>3</sup>

### INTRODUCTION

3. Inventories are tangible property held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumable stores and spare parts meant for replacement in the normal course.<sup>4</sup> Inventories normally comprise raw materials including components, work-in-process, finished goods including by-products, maintenance supplies, stores and spare parts, and loose tools.<sup>5</sup>

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\* Issued in November, 1994.

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

<sup>1</sup> Now known as Engagement Standards.

<sup>2</sup> The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.I of this Handbook.

<sup>3</sup> Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

<sup>4</sup> Servicing equipment, stand-by equipment and specialised spares of machinery (which are in the nature of 'insurance spares') are normally capitalised.

<sup>5</sup> The audit procedures, relating to shares debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are similar to those followed for audit of investments. Accordingly, this Guidance Note does not apply in respect of audit of shares, debentures and other securities held as stock-in-trade.

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

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

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

#### INTERNAL CONTROL EVALUATION

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

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

7. The auditor should also review specific controls over receipts, issues, physical inventories, and inventory records.

#### VERIFICATION

8. As in the case of other assets, the responsibility for properly determining the quantity and

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<sup>6</sup> The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative discussion on internal controls in relation to inventories.

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

9. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (Standard on Auditing (SA) 500, Audit Evidence). In carrying out an audit of inventories, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

- Existence - that all recorded inventories exist as at the year-end.
- Ownership - that all inventories owned by the entity are recorded and that all recorded inventories are owned by the entity.
- Valuation - that the stated basis of valuation of inventories is appropriate and properly applied, and that the condition of inventories is recognised in their valuation.

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

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

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

#### **EXAMINATION OF RECORDS**

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

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

#### ATTENDANCE AT STOCK-TAKING

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

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

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

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

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

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

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

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

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

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

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

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

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

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

#### **CONFIRMATIONS FROM THIRD PARTIES**

23. Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the stocks of the entity are held. The auditor should also directly obtain from the third parties written confirmation of the stocks held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. A proforma letter of request for confirmation to be used in such cases is given in **Appendix II** to this Guidance Note. Similarly, the auditor should also obtain confirmation from such third parties for whom the entity is holding significant amount of stocks. **Appendix-III** to this Guidance Note gives a proforma letter of request for confirmation to be used for this purpose.

#### **EXAMINATION OF VALUATION AND DISCLOSURE**

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

25. The auditor should satisfy himself that the valuation of inventories is in accordance with the normally accepted accounting principles and is on the same basis as in the preceding year. The generally accepted accounting principles<sup>7</sup> involved in the valuation of most types of inventories are dealt with in Accounting Standard (AS) 2, "Valuation of Inventories", issued by the Council of the Institute of Chartered Accountants of India.

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

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

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

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

#### **ANALYTICAL REVIEW PROCEDURES**

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

- (i) reconciliation of quantities of opening stocks, purchases, production, sales and closing stocks;
- (ii) comparison of closing stock quantities and amounts with those of the previous year;
- (iii) comparison of the relationship of current year stock quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;
- (iv) comparison of the composition of the closing stock (e.g., raw materials as a percentage of total stocks, work-in-process as a percentage of total stocks) with the corresponding figures for the previous year;
- (v) comparison of current year gross profit ratio with the gross profit ratio for the previous year;

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<sup>7</sup> It may be mentioned that the Manufacturing and Other Companies (Auditor's Report) Order, 1988 uses the words "normally accepted accounting principles".

- (vi) comparison of actual stock, purchase and sales figures with the corresponding budgeted figures, if available;
- (vii) comparison of yield with the corresponding figure for the previous year;
- (viii) comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;
- (ix) comparison of significant ratios relating to inventories with the industry norms, if available.

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

#### **SPECIAL CONSIDERATIONS IN CASE OF WORK-IN-PROCESS**

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

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

#### **MANAGEMENT REPRESENTATIONS**

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

#### **DOCUMENTATION**

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

**Illustrative Set of Instructions to be Issued by the  
Client to its Staff Responsible for Stock-Taking**  
(Ref. Paragraph 15)

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

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

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

**How to proceed with the work**

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

**Procedure for tagging**

- 5.1 You should place a tag on each pile, box, bin, etc., which is counted by you after recording the quantity, description, part number, condition of the stocks to the extent known (e.g., damaged stocks), etc., on the tag. You should proceed in proper order so as to ensure that no items are omitted. When the work of counting is completed you should hand over the remaining tags including soiled and damaged tags to Mr. PQ.
- 5.2 All items are required to be measured, weighed or counted in order to ascertain the exact quantity on hand. However, in respect of small items of in significant value, such as bolts, nuts (state here any other items which are known to be of small value), the quantities on hand may be estimated without actual counting etc. In the latter case, please state "estimated" on the tag.
- 5.3 Please ensure that proper identification is made by part number, description, etc., and that in the case of work-in-process, the last operation performed is clearly specified in accordance with the schedule attached to this Memorandum. No movement of any stock from one location to another should take place during the period of stock checking.

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

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

5.6 After obtaining the permission of the auditors<sup>8</sup>, instructions will be issued for the removal of the tags and a suitable person should be sent around in each department to detach the detachable portion of the tags, leaving the counterpart in the proper position. When they are collected, all such tags should be brought back to a central location, placed in serial order and tallied with the schedule prepared by Mr. PQ. After this has been done, the tags will be released to the Accounts Department which is concerned with the preparation of the inventory. Later on, when the inventory has been prepared, a check should be possible to see whether all the tags have been listed.

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

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

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

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

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

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

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

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

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<sup>8</sup> It is presumed that the auditors or their representatives are present at the time of stock-taking.

### III.44 Auditing Pronouncements

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

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

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

#### Stocks held by others

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

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

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

#### Work-in-Process

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

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

### Appendix II

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

*[Ref. Paragraph 23]*

(Letterhead of Entity)

[Date]

[Name and address of holder of inventories]

Dear Sir,

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

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

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

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

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

Yours faithfully,

(Signature of responsible official of the entity)

**Appendix III**

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

*[Ref. Paragraph 23]*

[Letterhead of Entity]

[Date]

[Name and address of owner of inventories]

Dear Sir,

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

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

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

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

Yours faithfully,

(Signature of responsible official of the entity)

**Representation Letter for Inventories**

*[Ref. Paragraph 33]*

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

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

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

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

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

2. All quantities were determined by actual physical count or weight or measurement that was taken under our supervision and in accordance with written instructions, on ..... (date/dates of physical verification), except as follows:<sup>9</sup>

.....  
 .....

<sup>9</sup> Where physical verification of inventories is carried out at a date other than the closing date, this paragraph may be modified as below:

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

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

.....  
 .....

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

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

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

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

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

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

.....  
 .....

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

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

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

Yours faithfully,

(Signature of responsible official of the entity)

Clarification\*\*\*

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

*(Refer Paragraph 33)*

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

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

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

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

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\*\*\* Published in September, 1999 issue of "The Chartered Accountant", p.66.

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

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The following is the text of the Guidance Note on Audit of Debtors, Loans and Advances issued by the Auditing Practices Committee (APC)<sup>+</sup> of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)<sup>1</sup> issued by the Institute.

1. Paragraph 2.1 of the "Preface to the Statements on Standard Auditing Practices"<sup>2</sup> issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Paragraph 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Debtors, Loans and Advances, Chapter-7 of the *Statement on Auditing Practices*, titled 'Debtors, Loans and Advances', shall stand withdrawn. In due course of time, the entire *Statement of Auditing Practices* shall be withdrawn.<sup>3</sup>

### INTRODUCTION

3. Debtors, loans and advances may constitute a significant proportion of the total assets of an entity. Debtors represent the amounts due to an entity for goods sold or services rendered or in respect of other similar contractual obligations, but do not include the amounts which are in the nature of loans or advances. Loans represent the claims of an entity in respect of such contractual obligations as moneys lent. Advances represent payments made on account of, but before completion of, a contract or before acquisition of goods or receipt of services. For purposes of this Guidance Note, debtors, loans and advances include instruments such as bills of exchange, promissory notes and similar other instruments, evidencing debtors, loans and advances.

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\* Published in June, 1994 issue of 'The Chartered Accountant'.

<sup>+</sup> Now known as the Auditing and Assurance Standards Board (AASB).

<sup>1</sup> Now known as Engagement Standards.

<sup>2</sup> The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.I of this Handbook.

<sup>3</sup> Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

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

#### INTERNAL CONTROL EVALUATION

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

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

- (i) The basis on which credit limits for customers are to be determined should be clearly laid down. The credit limits fixed in respect of individual customers should be approved by an official independent of the sales department. These limits should be checked before orders are accepted from the customers. There should also be a system of periodic review of the credit limits.
- (ii) The procedure should ensure prompt recording of debts and realisations and of linking receipts with outstandings.
- (iii) There should be a procedure for preparation of aging schedule of debtors at regular intervals. The schedules should be reviewed by a responsible official and necessary action initiated in respect of overdue accounts.
- (iv) Statements of account should be sent to all debtors at periodic intervals. They should be prepared and despatched by a person independent of the ledger-keeper. The debtors should be requested to confirm the balances as per the statements with reference to their own records. The confirmations received should be reviewed by a person independent of the ledger-keeper and the person responsible for preparing the statements of account, and necessary action taken in case of discrepancies.
- (v) All material adjustments in debtors' accounts, particularly those relating to rebates, allowances, commissions etc., should require approval of the competent authority. Similarly, any write-off of bad debts should require approval of the competent authority.
- (vi) There should be a system of periodic reconciliation of various debtor balances with related control accounts.

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

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

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

#### VERIFICATION

6. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, *Audit Evidence*). In carrying out an audit of debtors, loans and advances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

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

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

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

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

#### **EXAMINATION OF RECORDS**

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

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

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

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

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

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

- (a) The terms of credit have been repeatedly ignored.
- (b) There is stagnation, or lack of healthy turnover, in the account.
- (c) Payments are being received but the balance is continuously increasing.
- (d) Payments, though being received regularly, are quite small in relation to the total outstanding balance.
- (e) An old bill has been partly paid (or not paid), while later bills have been fully settled.

- (f) The cheques received from the debtor have been repeatedly dishonoured.
- (g) The debt is under litigation, arbitration, or dispute.
- (h) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues e.g., a debtor has either become insolvent, or has closed down his business, or is not traceable.
- (i) Amounts due from employees, which have not been repaid on termination of employment.
- (j) Collection is barred by statute of limitation.

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

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

14. The auditor should examine whether the contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.<sup>5</sup>

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

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

16. In the case of loans and advances, an important aspect to be examined by the auditor is whether the entity is empowered to make loans. In many cases, the statute governing the entity may contain restrictions or conditions about the amount of loans, purposes for which loans may be granted, parties to which loans may be granted etc. Similarly, the internal regulations of the entity may also prescribe the procedure to be followed for making the loans. For instance, in the case of companies, sections 292, 295 and 370 place restrictions on the making of loans by companies.<sup>6</sup> The competence of the borrower to receive the loan may also affect the legality and, hence, the recoverability of the loan. The auditor should examine the

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

<sup>6</sup> For a detailed study of this aspect, reference may be made to the Institute's publication titled *A Guide to Company Audit*. Similarly, in the case of entities like banks, insurance companies, etc., reference may be made to the relevant publication(s) of the Institute, e.g., *Guidance Note on Audit of Banks*, *Guidance Note on Audit of Companies Carrying on General Insurance Business*, *Guidance Note on Companies Carrying on Life Insurance Business*, *Guide to Audit of Cooperative Societies*, etc.

loan documents and other evidence with reference to the above while determining the legality and recoverability of the loans made by the entity.

17. The auditor should ascertain whether the parties to whom loans and advances have been made have complied with the terms and conditions relating to payment of interest, repayment of loans or adjustment of advances, etc. In the case of defaults, e.g., where the repayment of loans or advances or the payment of interest are overdue, the auditor should consider whether such defaults are indicative of unwillingness or inability of the parties concerned to make the payment.

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

19. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, the auditor of a company covered by the Manufacturing and Other Companies (Auditor's Report) Order, 1988<sup>7</sup>, is required to state in his report whether the terms and conditions on which loans and advances have been made are *prima facie* prejudicial to the interests of the company. Similarly, clause (a) of sub-section (1A) of section 227 of the Companies Act, 1956, requires the auditor to inquire "whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members".

#### DIRECT CONFIRMATION PROCEDURE

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

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

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<sup>7</sup> The Department of Company Affairs has notified the Companies (Auditor's Report) Order, 2003 in June 2003 in terms of the powers given to it under section 227(4A) of the Companies Act, 1956.

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

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

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

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

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

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

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

28. Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous, this may be done on a sample basis. The sample list of debtors to be circularized, in order to be meaningful, should be based on a complete list of all debtor accounts. While selecting the debtors to be circularized, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts

with credit balances. In addition, the auditor should select accounts in respect of which provisions have been made or balances have been written off during the period under audit or earlier years and request confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with nil balances. The nature of the entity's business (e.g., the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.

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

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

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

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

#### **ANALYTICAL REVIEW PROCEDURES**

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

- (a) comparison of closing balances of debtors, loans and advances with the corresponding figures for the previous year;

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

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

#### **DISCLOSURE**

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

#### **MANAGEMENT REPRESENTATIONS**

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

#### **DOCUMENTATION**

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

Illustrative Letter of Confirmation to be Sent to Debtors-Positive Form

[Ref. Paragraph 25]

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly confirm directly to our auditors (name and address of the auditors) that the balance of Rs..... due by you as on ....., as shown by our books, is correct. The details of the balance are as under:<sup>8</sup>

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

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

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

Kindly return this form in its entirety.

Yours Faithfully,

(Signature of responsible official of the entity)

.....

<sup>8</sup> In case the list of invoices forming the balance is too large, these details may not be given.

(Do not perforate the form at this point)

(Name and Address of entity)

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

OR

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

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

Date

(Signature of debtor/responsible official)

## Appendix II

### Illustrative Letter of Confirmation to be Sent to Debtors-Negative Form

[Ref. Paragraph 26]

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly write directly to our auditors (name and address of the auditors) if the balance of Rs. due by you as on \_\_\_\_\_ as shown by our books, is not correct, giving details of the differences. The details of the balance are as under:<sup>9</sup>

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

<sup>9</sup> In case the list of invoices forming the balance is too large, these details may not be given.

### III.60 Auditing Pronouncements

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

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

Yours faithfully,

(Signature of responsible official of the entity)

### Appendix III

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

*[Ref. Paragraph 35]*

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

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Ltd. as of ....., 19.., and for the year then ended, we certify that the following items appearing in the books as at .....(date of the Balance Sheet) are considered good and fully recoverable with the exception of those specifically shown as "doubtful" in the Balance Sheet.

Sundry Debtors                      Rs.

Loans and Advances<sup>10</sup>      Rs.

Yours faithfully,

(Signature of responsible official of the entity)

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<sup>10</sup> It may be pointed out that a similar certificate regarding deposits made by the entity may also be obtained by the auditor in appropriate cases.

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## GUIDANCE NOTE ON AUDIT OF INVESTMENTS\*

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The following is the text of the Guidance Note on Audit of Investments issued by the Auditing Practices Committee (APC)<sup>1</sup> of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)<sup>2</sup> issued by the Institute.

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices"<sup>3</sup> issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee, It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn.<sup>4</sup> With the issuance of this Guidance Note on Audit of Investments, Chapter 4 of the *Statement on Auditing Practices*, titled "Investments", shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.<sup>5</sup>

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\* Issued in November, 1994.

<sup>1</sup> Now known as the Auditing and Assurance Standards Board (AASB).

<sup>2</sup> Now known as Engagement Standards.

<sup>3</sup> The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in Vol.I of this Handbook.

<sup>4</sup> This Guidance Note does not deal with special aspects of audit of investments of retirement benefit plans, life insurance enterprises, mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956. The special aspects of audit of investments of some of these institutions have been dealt with in other publications of the Institute, e.g., *Guidance Note on Audit of Banks*, *Guidance Note on Audit of Companies Carrying on General Insurance Business*, *Guidance Note on Companies Carrying on Life Insurance Business*. It may also be noted that in the case of certain types of entities, e.g., companies, banks, insurance companies, co-operative societies, etc., the question of compliance with the legal requirements assumes special importance. Appendix I to this Guidance Note contains a brief description of the main provisions of the statutes governing these types of entities in so far as they relate to investments. It may be emphasised that the Appendix is only illustrative and not exhaustive. Moreover, the legal requirements may change from time to time and, therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

<sup>5</sup> Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

### INTRODUCTION

3. Investments are assets held by an entity for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing entity<sup>6</sup> Investments are classified as 'current investments' and 'long term investments'. A *current investment* is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A *long term investment* is an investment other than a current investment.<sup>7</sup>

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

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

### INTERNAL CONTROL EVALUATION

5. The auditor should study and evaluate the system of internal control relating to investments to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to investments.<sup>8</sup>

- (a) *Control over acquisition, accretion and disposal of investments:* There should be proper authority for sanction, acquisition and disposal of investments (including renunciation of rights). It should also be ensured that investments are made in accordance with the legal requirements governing the entity as also with its internal regulations, e.g., the provisions of the articles of association, rules and regulations, trust deed, etc.
- (b) *Safeguarding of investments:* The investments should be in the name of the entity as far as possible. The legal requirements in this behalf, if any, should be complied with. There

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<sup>6</sup> It may be clarified that the term 'investments' covers only such securities as are beneficially owned by the entity and not those held by it on behalf of others.

<sup>7</sup> It may be clarified that inventories, as defined in Accounting Standard (AS) 2, "Valuation of Inventories", issued by the Institute of Chartered Accountants of India are not investments. However, the recommendations of this Guidance Note also apply, to the extent relevant to shares, debentures and other securities held as stock-in-trade. Fixed assets (other than investment properties), as defined in Accounting Standard (AS) 10, "Accounting for Fixed Assets", issued by the Institute, are also not investments.

<sup>8</sup> The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the *Internal Control Questionnaire*, issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to investments.

should exist a proper system for the safe custody of all scrips or other documents of title to the investments belonging to the entity.

- (c) *Controls relating to title to investments:* It should be ensured that in cases where the title does not pass on to the entity immediately on acquisition, the same is transferred to the entity in due course of time, along with the benefits that might have accrued since the acquisition of the investments. It should be ensured that there is no undue time-lag in the execution of various stages of the transactions.
- (d) *Information controls:* These controls should ensure that reliable information is available for recording acquisitions (including by way of conversion of securities, right issues or other entitlements, under schemes of amalgamation, acquisition, etc.), accretions and disposals, and for ascertaining the market values etc. Detailed records regarding acquisition, disposal etc. of the investments should be maintained along with proper documentation.

#### VERIFICATION

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

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

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

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

#### VERIFICATION OF TRANSACTIONS

8. The auditor should ascertain whether the investments made by the entity are within its authority. In this regard, the auditor should examine whether the legal requirements governing the entity, insofar as they relate to investments, have been complied with and the investments made by the entity are not *ultra vires* the entity. Apart from the above, the auditor should also ensure that any other covenants or conditions which restrict, qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the entity.

9. The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other

similar evidence. The auditor should pay special attention to ascertaining whether the investments have been purchased or sold cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right or cum-bonus/ex-bonus. He should check whether proper adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

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

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

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

#### **PHYSICAL INSPECTION**

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

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

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

such cases, the auditor should verify the interim and other acknowledgments issued by dealers as well as the year-end confirmation certificates of the depository organisations.

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

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

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

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

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

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

22. The auditor should keep in mind the provisions of section 227(1A)(c) which requires that the auditor of a company, not being an investment company within the meaning of section 372 of the Companies Act, 1956 or a banking company, should enquire whether so much of the

assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they are purchased by the company.<sup>9</sup>

23. In case the entity is a finance, investment, chit fund, *nidhi* or mutual benefit company and is dealing or trading in shares, securities, debentures or other investments, the auditor has to state in his report (by virtue of the requirements of the Manufacturing and Other Companies (Auditor's Report) Order, 1988<sup>\*\*</sup>, issued under section 227(4A) of the Companies Act, 1956) whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein as also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemptions granted under section 49 of the Companies Act, 1956.<sup>10</sup>

#### IMMOVABLE PROPERTIES

24. Where immovable properties are held as investments, the auditor should verify them in the same manner as in the case of immovable properties held as fixed assets.<sup>11</sup>

#### EXAMINATION OF VALUATION AND DISCLOSURE

25. The auditor should satisfy himself that the investments have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.<sup>12</sup> **Appendix III** to this Guidance Note discusses, by way of illustration, the disclosure requirements of some of the Acts. The auditor should also examine whether the method of valuation followed by the entity is consistently applied.

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

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

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<sup>9</sup> For a detailed discussion on this aspect reference may be made to the "Statement on Qualification in Auditor's Report", issued by the Institute of Chartered Accountants of India (ICAI).

*(The readers may note that the Council, at 269th meeting, held from July 18 to 20, 2007, decided to withdraw the "Statement on Qualification in Auditor's Report" except paragraphs 2.1 to 2.30 dealing with reporting under section 227 (1A) of the Companies Act, 1956 and to rename the Statement as "Statement on Reporting under section 227(1A) of the Companies Act, 1956".)*

<sup>\*\*</sup> Currently, the Companies (Auditor's Report) Order, 2003 (Revised 2005) is in force in terms of section 227(4A) of the Companies Act, 1956.

<sup>10</sup> For a detailed discussion on this aspect, reference may be made to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India.

<sup>11</sup> Reference may be made in this regard to the *Guidance Note on Audit of Fixed Assets*, issued by the Institute of Chartered Accountants of India.

<sup>12</sup> Reference may be made in this regard to Accounting Standard 13, *Accounting for Investments*, issued by the Institute of Chartered Accountants of India.

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

#### **ANALYTICAL REVIEW PROCEDURES**

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

#### **MANAGEMENT REPRESENTATIONS**

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

#### **DOCUMENTATION**

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

### **Appendix I**

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

*(Ref. Paragraph 2)*

This Appendix contains an illustrative description of the legal provisions regarding investments as contained in the Companies Act, 1956, Banking Regulation Act, 1949, Insurance Act, 1938, and the Cooperative Societies Act, 1912. It may be emphasised that this Appendix is only illustrative in nature and is not intended to give an exhaustive description of all the relevant legal requirements applicable to different types of entities. Moreover, the legal requirements may change from time to time and therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### III.70 Auditing Pronouncements

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

#### Appendix II

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

*(Ref. Paragraph 17)*

[Letterhead of entity]

[Date]

..... (Bank)

.....

.....

Dear Sirs,

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

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

We would request you to state NIL wherever applicable.

Yours faithfully,

(to be signed by person authorised to operate accounts)

#### Appendix III

##### Disclosure Requirements Relating to Investments

*(Ref. Paragraph 25)*

To illustrate the manner of disclosure of investments in the financial statements, this Appendix discusses the requirements of the Companies Act, 1956, the Banking Regulation Act, 1949, and the Insurance Act, 1938, insofar as they relate to disclosure of information regarding

investments in the financial statements prepared and presented in accordance with the provisions of these statutes. As regards the co-operative societies, the form and content of their financial statements are governed by the rules framed by the State Government concerned. It may be emphasised that, in every case, there should be an adequate disclosure of all relevant information to facilitate proper understanding of the financial statements by the users.

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

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

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

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

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

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

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

- I. Investments in India in
  - (i) Government securities
  - (ii) Other approved Securities

### III.72 Auditing Pronouncements

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- (iii) Shares
- (iv) Debentures and Bonds
- (v) Subsidiaries and/or joint ventures
- (vi) Others (to be specified)

Total:

#### II. Investments outside India in

- (i) Government securities (including local authorities)
- (ii) Subsidiaries and/or joint ventures abroad
- (iii) Other investments (to be specified)

Total:

Grand Total: (I &II)

#### Requirements of the Insurance Act, 1938

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

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

- ◆ Preference or guaranteed shares of any railway out of India
- ◆ Railway Ordinary Stocks (i) in India (ii) out of India
- ◆ Other Debentures and Debenture stock of companies incorporated (i) in India (ii) out of India
- ◆ Other guaranteed and preference stocks and shares of companies incorporated (i) in India (ii) out of India
- ◆ Other ordinary stocks and shares of companies incorporated (i) in India (ii) out of India
- ◆ Holdings in Subsidiary companies

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

#### Appendix IV

#### Representation Letter for Investments

*(Ref. Paragraph 29)*

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

(Letterhead of Entity)

[Date]

[Name and Address of the Auditor]

Dear Sir,

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

1. The current investments as appearing in the balance sheet consist of only such investments as are by their nature readily realisable and intended to be held for not more than one year from the respective dates on which they were made. All other investments have been shown in the balance sheet as 'long-term investments'.
2. Current investments have been valued at the lower of cost and fair value. Long-term investments have been valued at cost, except that any permanent diminution in their value has been provided for in ascertaining their carrying amount.
3. In respect of offers of right issues received during the year, the rights have been either been subscribed to, or renounced or allowed to lapse. In no case have they been renounced in favour of third parties without consideration which has been properly accounted for in the books of account.

### III.74 Auditing Pronouncements

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4. All the investments produced to you for physical verification belong to the entity and they do not include any investments held on behalf of any other person.
5. The entity has clear title to all its investments including such investments which are in the process of being registered in the name of the entity or which are not held in the name of the entity. There are no charges against the investments of the entity except those appearing in the records of the entity.

Yours faithfully,

(Signature of responsible official of the entity)

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## GUIDANCE NOTE ON AUDIT OF MISCELLANEOUS EXPENDITURE [REVISED]\*

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### INTRODUCTION

1. The following is the text of the Guidance Note on Audit of Miscellaneous Expenditure. This Guidance Note provides guidance on audit procedures to be applied while auditing miscellaneous expenditure. This Guidance Note also provides guidance for audit of items that generally constitute miscellaneous expenditure when Accounting Standard (AS) 26, "Intangible Assets" comes into effect or is voluntarily applied by an enterprise in accounting for intangible assets. This Guidance Note, however, does not provide any guidance on audit of intangible assets that are recognised in accordance with AS 26. The guidance provided herein is restricted to only those items which were hitherto (before application of AS 26—whether mandatory or otherwise) being classified as items of miscellaneous expenditure, but because of application of AS 26, accounting treatment of such items would change.

2. 'Miscellaneous expenditure' shown in the balance sheet of companies (or shown under this or some other appropriate heading in the balance sheet of other enterprises) embraces within its fold a variety of items of expenditure which are not entirely charged to income in the year in which they are incurred, but are carried forward in the balance sheet to be written-off in subsequent periods. Unless some benefit from the expenditure can reasonably be expected to be received in future and unless the amount of such benefit is reasonably determinable, there is no justification for carrying forward the expenditure for being written-off in subsequent periods. Also, the amount of expenditure to be carried forward should not exceed the expected future revenue/other benefits related to the expenditure.

3. The Guidance Note deals with the audit considerations related to the following items that normally constitute 'miscellaneous expenditure':

- (a) preliminary expenses;
- (b) expenses including commission or brokerage on underwriting or subscription of shares or debentures including discount allowed on the issue of shares or debentures;
- (c) research and development expenditure, etc.

4. The Council of the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 26, "Intangible Assets". The objective of this AS 26 is to prescribe the

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\* Issued in September, 2003. The Guidance Note on Audit of Miscellaneous Expenditure shown in the Balance Sheet shall stand withdrawn in respect of audit of financial statements of enterprises for which AS 26, "Intangible Assets" has become mandatory and in respect of entity that has chosen to apply AS 26 to account for intangible assets.

accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. AS 26 requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The accounting standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets. Consequently, the accounting treatment of some of the items that generally constitute 'miscellaneous expenditure' would change as and when an enterprise adopts Accounting Standard 26 'Intangible Assets' to account for intangible assets.

5. Accounting Standard (AS) 26, "Intangible Assets" comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for the following:

- (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.
- (ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory from that date. The Accounting Standard, however, encourages earlier application.

6. In respect of intangible items appearing in the balance sheet as on the aforesaid date, i.e., 1-4-2003 or 1-4-2004, as the case may be, the Standard has limited its application as stated in paragraph 99 of AS 26. From the date of this Standard becoming mandatory for the concerned enterprises, the following stand withdrawn:

- (i) Accounting Standard (AS) 8, "Accounting for Research and Development";
- (ii) Accounting Standard (AS) 6, "Depreciation Accounting", with respect to the amortisation (depreciation) of intangible assets; and
- (iii) Accounting Standard (AS) 10, "Accounting for Fixed Assets" - paragraphs 16.3 to 16.7, 37 and 38.

7. Since AS 26, applies to different entity from different dates, it may happen that certain enterprises, till the date the standard becomes mandatory for them may continue to defer the expenditure incurred on items that normally constitute "miscellaneous expenditure". Once an entity applies AS 26 to account for intangible assets, the expenditure incurred on items that normally constitute miscellaneous expenditure shall be governed by the Standard, except in the case of already appearing miscellaneous expenditure in the balance sheet which is to be accounted for using paragraph 99 of AS 26.

8. The following features of miscellaneous expenditure have an impact on the related audit procedures.

- (a) The items of expenditure included under this heading do not represent any tangible asset.
  - (b) The expenditure on these items is usually of a non-recurring nature.
  - (c) There is a justification for deferring the expenditure on the basis that the benefits from the expenditure can reasonably be expected as flowing into the future the amount of such benefits is reasonably determinable, and the amount of deferred expenditure does not exceed the expected future benefits related thereto.
  - (d) Unless some fresh expenditure is incurred, the balance in these items reduces each year by the amount written-off in the year.
9. The auditor's primary objective in audit of items that generally constitute miscellaneous expenditure is to satisfy himself that —
- (a) in case where some items are shown in the balance sheet under the head Miscellaneous Expenditure whether it is proper to defer the expenditure;
  - (b) in case where some items are shown in balance sheet under the head 'Miscellaneous Expenditure', the period of amortisation of the expenditure is reasonable;
  - (c) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral;
  - (d) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue/other benefits related to the expenditure continue to exceed the amount of unamortised expenditure.
  - (e) Where the entity has applied AS 26, for accounting for items that normally constitute miscellaneous expenditure, whether the same has been done in accordance with the Standard and the already appearing items under the head miscellaneous expenditure have been dealt with in accordance with paragraph 99 of AS 26.

#### INTERNAL CONTROL EVALUATION

10. The auditor should study and evaluate the system of internal control relating to the various items of miscellaneous expenditure to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects.
- (a) There should be a system of control over expenditure incurred on these items. An effective method of exercising such control is budgeting which, apart from ensuring proper authorisation of the expenditure incurred, also shows in general how effectively such expenditure is being controlled. This is accomplished through periodical comparisons of actual with budgeted figures.
  - (b) Accountability should be established over each item of such expenditure. This can be achieved, *inter alia*, by up-to-date maintenance of proper records.

- (c) The system should ensure that reliable information (including reports of experts) is available for assessment of the results achieved against the objectives and estimates of the expenditure determined originally.

#### **VERIFICATION**

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

12. While verifying an item of miscellaneous expenditure in the year in which the relevant expenditure is incurred, the auditor should satisfy himself regarding the amount of such expenditure and its deferral as also regarding the reasonableness of the period of amortisation of the expenditure. Till the amount is fully amortised, the auditor should examine every year that a proper amount is amortised during the year by way of a charge to income for the year (and not as its appropriation). The auditor should also examine every year that the criteria which previously justified the deferral of the expenditure continue to be met. If those criteria no longer apply, the auditor should examine whether the unamortised balance has been charged as expense immediately. Where the auditor finds that the criteria for deferral continue to be met but the amount of unamortised balance of the expenditure exceeds the expected future revenue/other benefits related thereto, the auditor should examine whether such excess has been charged as an expense immediately.

13. The applicability of AS 26 on items that generally constitute miscellaneous expenditure and special considerations in audit of various items of miscellaneous expenditure when AS 26 is applied are discussed in subsequent paragraphs of this Guidance Note.

#### **PRELIMINARY EXPENSES**

14. Preliminary expenses are the expenses relating to the formation of an enterprise. For example, in the case of a company, preliminary expenses would normally include the following.

- (a) Legal cost in drafting the memorandum and articles of association.
- (b) Fees for registration of the company.
- (c) Cost of printing of the memorandum and articles of association and statutory books of the company.
- (d) Any other expenses incurred to bring into existence the corporate structure of the company.

15. Paragraph 55 of AS 26 requires that expenditure on an intangible item should be recognised as an expense when it is incurred unless:

- (a) it forms part of the cost of an intangible asset that meets the recognition criteria laid down in paragraphs 19-54 of AS 26; or

(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

16. Paragraph 56 of AS 26 provides some examples where the expenditure is recognised as an expense when it is incurred. The examples given include, expenditure on start-up of activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs).

17. Preliminary expenses, therefore, incurred on or after the date on which the Standard becomes mandatory for an enterprise or the preliminary expenses incurred on or after the date on which the enterprise opts to apply the Standard in the preparation and presentation of financial statements would be written off in the year in which they are incurred. The expenditure on preliminary expenses shall not be carried forward in the balance sheet to be written off in subsequent accounting periods.

18. Preliminary expenses already shown in the balance sheet on the date the Standard is first applied would be required to be accounted for in accordance with the requirements laid down by paragraph 99 of AS 26.

19. The auditor should verify these expenses with reference to supporting documents such as invoices and contracts relating to these expenses. In the case of a company, the auditor should also examine that the reimbursement of such expenses to promoters is in accordance with the disclosures made in the prospectus. Compliance with legal provisions regarding reimbursement of the promoters' expenses should be specifically examined. In addition to the audit procedures mentioned above, the auditor should also apply the following audit procedures with regard to preliminary expenditure:

- (a) The auditor should verify whether the preliminary expenses incurred on or after the date the Standard is applied by the enterprise are entirely charged to the profit and loss account in the year in which they are incurred.
- (b) In the case of preliminary expenses already appearing in the balance sheet on the date the Standard is applied, the auditor should satisfy himself that the estimate made by the management of the enterprise of the useful life of the preliminary expenses is appropriate.
- (c) The auditor should verify whether the carrying amount of the preliminary expenses already appearing in the balance sheet is eliminated with a corresponding adjustment to the opening balance of the revenue reserve in case the amortisation period determined under paragraph 63 of AS 26 has already expired.

- (d) The auditor should satisfy himself that the preliminary expenses already appearing in the balance sheet are being amortised in accordance with the requirements of AS 26 in case the amortisation period determined under paragraph 63 of AS 26 has not expired.

#### **EXPENSES RELATED TO SUBSCRIPTION OR ISSUE OF SHARES**

20. Expenses related to subscription or issue of shares include commission or brokerage on underwriting or subscription of shares or debentures, discount allowed on issue of shares or debentures. AS 26 excludes from its scope certain activities or transactions which are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such accounting issues, *inter alia*, are accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares.

21. The auditor should examine whether the payment of brokerage, commission, etc., is authorised by articles of association or other rules/regulations and is in accordance with the provisions of the relevant statute.

22. The auditor should also examine whether the rates of commission paid or payable to brokers and underwriters are in accordance with the disclosures made in the prospectus. The auditor should verify the commission with reference to the agreements with brokers and underwriters.

23. The auditor should examine the certificate issued by the merchant bankers with regard to commission payable to underwriters, and ensure that the payment made to underwriters is in accordance with such certificate.

24. Other expenses on issue of shares or debentures, such as fees of the managers to the issue, fees of the registrars to the issue including mailing and handling charges, fees of the advisors to the issue, advertisement expenses, expenses on printing and supply of prospectus and application forms, expenses on printing of share/debenture certificates, etc., should be verified with reference to supporting documents such as invoices, agreements, etc. The auditor should also examine whether the limits on such expenses as laid down in the applicable statute have been complied with.

#### **RESEARCH AND DEVELOPMENT EXPENDITURE**

25. Entities generally incur expenditure on research and development activities. Paragraph 41 of AS 26, Intangible Assets provides that no intangible asset arising from research or from the research phase of an internal project should be recognised and should therefore, be charged as an expenses, as and when incurred. According to AS 26, expenditure incurred in the development or during the development phase of an enterprise is required to be recognised as an intangible asset if, and only if, the requirements of paragraph 44 of AS 26 are met. It may be noted that the expenditure incurred on research or incurred during the research phase of an enterprise are required to be recognised as an expense when such expenses are incurred.

26. The expenditure, therefore, incurred in the development or during the development phase of an enterprise on or after the date on which the Standard becomes mandatory for an enterprise or the preliminary expenses incurred on or after the date on which the enterprise opts to apply the Standard in the preparation and presentation of financial statements would be recognised as an asset if the requirements of paragraph 44 of AS 26 are met. Where the expenditure qualifies to be recognised as an intangible asset then the requirements, related to carrying amount of the intangible asset, its amortisation and disclosures, laid down by AS 26 shall apply to the development expenditure.

27. The development expenditure shown in the balance sheet on the date on which the Standard is first applied shall be accounted for in accordance with the requirements of paragraph 99 of AS 26 from that date. If any expenditure incurred on the research or during the research phase of an enterprise already appears in the balance sheet, the same shall also be required to be accounted for in accordance with paragraph 99 of AS 26 from the date the Standard is first applied by the enterprise.

28. The auditor should perform the following audit procedures with regard to research and development expenditure:

- (a) The auditor should verify the research expenditure and development expenditure with reference to supporting documents such as purchase invoices, agreements with third parties etc. A variety of expenses may be incurred by an enterprise during the research phase or development phase of an enterprise. The auditor should apply the procedures mentioned in the Guidance Note on Audit of Expenses with regard to the items of expenditure covered therein.
- (b) The auditor should verify that the expenses incurred on research or incurred during the research phase of an internal project on or after the date the Standard is first applied by the enterprise are entirely charged to the profit and loss account in the year in which they are incurred;
- (c) In the case of research and development expenses already appearing in the balance sheet on the date the Standard is first applied, the auditor should satisfy himself that the estimate made by the management of the enterprise of the useful life of such expenses is appropriate;
- (d) The auditor should verify whether the carrying amount of the research and development expenses already appearing in the balance sheet is eliminated with a corresponding adjustment to the opening balance of the revenue reserve in case the amortisation period determined under paragraph 63 of AS 26 has already expired.
- (e) The auditor should satisfy himself that the research and development expenses already appearing in the balance sheet are being amortised in accordance with the requirements of AS 26 in case the amortisation period determined under paragraph 63 of AS 26 has not expired.
- (f) The auditor should also examine that the intangible asset recognised is accounted for in accordance with the requirements of AS 26.

- (g) Where an intangible asset has been recognised, the auditor should verify whether the asset so recognised is tested for impairment in accordance with Accounting Standard (AS) 28, "Impairment of Assets". The auditor should examine whether the test of impairment is appropriate and where impairment has occurred, an impairment loss has been provided for in the financial statements.

#### **Other Items**

29. Expenditure during construction period includes a variety of expenditure. Some of the expenditure during construction period may also constitute miscellaneous expenditure. Where an enterprise applies AS 26 to account for intangible assets, either voluntarily or is required to do so by operation of the accounting standard itself, the accounting treatment of some of the items of expenditure during construction period might be governed by the principles enunciated in AS 26. The auditor, in such cases, should verify the expense incurred during the construction period with reference to the supporting documents, such as, invoices, contracts, etc., relating to those expenses. The auditor should also verify that the requirements of AS 26 have been complied with in accounting for such items.

30. In case where an enterprise does not apply AS 26 to account for intangible assets because it is not required to do so, the auditor apart from verifying the expense incurred during the construction period with reference to the supporting documents, such as, invoices, contracts, etc., relating to those expenses should also examine whether the deferral and the amortisation of expenditure incurred during the construction period are in accordance with recognised accounting policies and practices (*see*, for example, Guidance Note on Treatment of Expenditure During Construction Period, issued by the Institute of Chartered Accountants of India). Where the entity incurs heavy expenditure of a revenue nature during the year, the benefits of which are likely to extend beyond that year, the expenditure may sometimes be deferred and written-off over the number of years for which the benefits are expected to be derived by the entity. Some instances of such expenditure are removal of business from one location to another and massive advertisement in one year to introduce a product or develop a market. In such cases, the auditor should examine whether the deferral of the expenditure meets the relevant criteria and whether the amount of periodic write-off of the expenditure is appropriate.

#### **DISCLOSURES**

31. The auditor should examine whether the financial statements contain adequate disclosures as required by AS 26. The auditor should also examine that the financial statements disclose the accounting policy with regard to miscellaneous expenditure. On the first occasion when AS 26 is applied by an enterprise for accounting for items of miscellaneous expenditure, the financial statements should also disclose the change in accounting policy with regard to miscellaneous expenditure in accordance with the requirements of paragraph 32 of Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies".

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

The following is the text of the Guidance Note on Audit of Cash and Bank Balances issued by the Auditing Practices Committee (APC)<sup>1</sup> of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)<sup>2</sup> issued by the Institute.

1. Para 2.1 of the *Preface to the Statements on Standard Auditing Practices*<sup>3</sup>, issued by the Institute of Chartered Accountants of India, states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Cash and Bank Balances, Chapter 6 of the *Statement on Auditing Practices*, titled 'Cash and Bank Balances', shall stand withdrawn.<sup>4</sup> In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.<sup>5</sup>

### INTRODUCTION

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

4. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, Audit Evidence). In

\* Published in November, 1995 issue of 'The Chartered Accountant'.

<sup>1</sup> Now known as the Auditing and Assurance Standards Board (AASB).

<sup>2</sup> Now known as Engagement Standards.

<sup>3</sup> The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.

<sup>4</sup> The special aspects of audit of cash and bank balances in the case of banks are dealt with in the Guidance Note on Audit of Banks (edn. 2008).

<sup>5</sup> Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

carrying out an audit of cash and bank balances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

- Existence - that recorded cash and bank balances exist as at the year-end.
- Rights and obligations - that recorded cash and bank balances represent the assets of the entity.
- Completeness - that there are no unrecorded cash and bank balances.

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

#### INTERNAL CONTROL EVALUATION

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

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

#### VERIFICATION

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

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<sup>6</sup> The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the *Internal Control Questionnaire*, issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to cash and bank balances.

### VERIFICATION OF CASH BALANCES

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

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

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

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

11. If, during the course of the audit, it comes to the attention of the auditor that the entity is consistently maintaining an unduly large balance of cash- on-hand, he should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balances as shown by the books. If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

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

### VERIFICATION OF BANK BALANCES

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

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

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

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

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

18. Where a large number of cheques has been issued/deposited in the last few days of the year, and a sizeable proportion of such cheques has subsequently remained unpaid/uncleared, this may indicate an intention of understating creditors/debtors or understating/overstating bank balances. In such a case, it may be appropriate for the auditor to obtain confirmations from the parties concerned, especially in respect of cheques involving large amounts. The auditor should also examine whether a reversal of the relevant entries would be appropriate under the circumstances.

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

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

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

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

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

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

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

#### EXAMINATION OF VALUATION AND DISCLOSURE

26. The auditor should satisfy himself that cash and bank balances have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.<sup>7</sup> In this regard, the auditor should examine that following items are not included in cash and bank balances:

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

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

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

#### Appendix

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

*(Ref. Paragraph 13)*

[Letterhead of Entity]

[Name and Address of Bank]

[Date]

Dear Sirs,

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

<sup>7</sup> For valuation of foreign currency held as cash-in-hand and bank balances designated in foreign currencies, reference may be made to Accounting Standard 11, "Accounting for the Effects of Changes in Foreign Exchange Rates", issued by the Institute of Chartered Accountants of India.

### III.88 Auditing Pronouncements

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

Yours faithfully,

(Signature of person authorised to operate accounts)

\_\_\_\_\_  
Reply from  
(Bank)

[Name and Address of Auditors]

Dear Sirs,

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

Re : (Name of Client)

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

1. *Current Accounts in Credit*

Designation of Account	Amount
------------------------	--------

2. *Overdrawn Current Accounts, Overdraft Accounts or Cash Credit Accounts.*

Designation of Account	Amount	Security held (give brief description. In the case of securities please list fully)
------------------------	--------	---

3. *Loan Accounts*

Designation of Account	Amount	Security held (give brief description. In the case of securities please list fully)
------------------------	--------	---

4. *Fixed, Call and Short Deposit Accounts*

Amount	Interest Accrued	Due Date	Particulars of any to the closing date charges of liens
--------	------------------	----------	---

5. *Investments and Other Documents of Title Held in Safe Custody*

Designation.	Face value or number of shares held.
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6. *Margin against letters of credit Guarantees issued, etc.*

Designation of Account	Amount
------------------------	--------

7. *Bills for Collection*

Designation of Account	Amount	Due date
------------------------	--------	----------

8. *Bills Discounted or Purchased.*

Name of Drawee	Amount	Due date
----------------	--------	----------

9. *Letters of Credit Open and Outstanding*

In favour of	Amount not utilised	Valid upto
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10. *Guarantees given on behalf of clients*

In favour of	Amount.	Date of expiry
--------------	---------	----------------

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

Yours faithfully,

Name of Bank  
Designation of Signatory

## GUIDANCE NOTE ON AUDIT OF LIABILITIES\*

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The following is the text of the Guidance Note on Audit of Liabilities issued by the Auditing Practices Committee (APC)<sup>1</sup> of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)<sup>2</sup> issued by the Institute.

1. Para 2.1 of the Preface to the Standards on Auditing<sup>3</sup> issued by the Institute of Chartered Accountants of India states that the “main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.” Para 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.”
2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Liabilities, Chapter 9 of the *Statement on Auditing Practices*, titled ‘Liabilities’, shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn<sup>4</sup>.

### INTRODUCTION

3. Liabilities are the financial obligations of an enterprise other than owners’ funds.
4. Liabilities include loans and borrowings, trade creditors and other current liabilities, deferred payment credits, instalments payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable.
5. Special considerations may apply in the case of audit of liabilities of specialised entities like banks, financial institutions and venture capital funds.
6. Liabilities generally constitute a significant proportion of the total sources of funds of an entity. The audit of liabilities is primarily directed at ensuring that all known liabilities have

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\* Published in December, 1995 issue of ‘The Chartered Accountant’.

<sup>1</sup> Now known as the Auditing and Assurance Standards Board (AASB).

<sup>2</sup> Now known as Engagement Standards.

<sup>3</sup> The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.

<sup>4</sup> Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

been properly accounted for, since material omission or misstatement of liabilities vitiates the true and fair view of the financial statements.

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

8. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions [Standard on Auditing (SA) 500, Audit Evidence]. In carrying out an audit of liabilities, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to satisfy himself that all known liabilities are recorded and stated at fair and reasonable amounts.

### INTERNAL CONTROL EVALUATION

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

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

- (i) As far as possible, the following should be clearly specified:
  - ◆ the borrowing powers and limits;
  - ◆ persons authorised and competent to borrow;
  - ◆ terms of borrowings;
  - ◆ procedure for ensuring compliance with relevant legal requirements/internal regulations.
- (ii) Any variations in the terms of loans and borrowings should be truly approved/ratified in writing by competent authority.
- (iii) Security offered against loans and borrowings should be properly recorded and periodically reviewed.
- (iv) The records and documents should be kept in proper custody and reviewed periodically.
- (v) The system should bring out all cases of non-compliance with terms and conditions including amounts of principal and/or interest which have become overdue.
- (vi) Confirmation of balances should be obtained at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.
- (vii) There should be a proper procedure for year-end valuation of loans and borrowings, especially for those designated in foreign currencies.<sup>6</sup>

<sup>5</sup> The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the Internal Control Questionnaire, issued by the Institute of Chartered Accountants of India, which contains, *inter alia*, an illustrative list of internal controls in relation to creditors and borrowings.

<sup>6</sup> Reference may be made in this regard to Accounting Standard 11 (revised 2003), *Effects of Changes in Foreign Exchange Rates*, issued by the Institute of Chartered Accountants of India.

(b) *In respect of Trade Creditors*

- (i) The procedure should ensure proper recording of transactions and facilitate the linking of payments with outstandings.
- (ii) The payments made to creditors should be in line with the approved policies of the entity.
- (iii) There should be specific procedures for payments against duplicate invoices or other duplicate records as well as for payments against accounts which have remained unclaimed for quite some time.
- (iv) There should be a procedure for preparation of schedules of trade creditors at periodic intervals; this should be reviewed by a responsible person and necessary action initiated on overdue accounts.
- (v) Statements of account should be called for creditors at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.
- (vi) All adjustments in the creditors' accounts such as those relating to claims for returns, defectives, short receipts of goods, rebates, allowances and commissions etc., should require approval of competent authority. Similarly, any write-back of creditors' balances and escalation claims should be approved by competent authority.
- (vii) There should be appropriate cut-off procedures in relation to transactions affecting the creditor accounts.

(c) *In respect of other current liabilities, trade deposits and provisions*

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

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

**VERIFICATION**

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

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

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

## EXAMINATION OF RECORDS

### Loans and Borrowings

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

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

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

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

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

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

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

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

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

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

### Trade Creditors and Other Current Liabilities

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

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

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

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

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

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

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

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

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

### **Provisions**

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

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

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

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

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

33. In case the entity has made the provision for taxation on the basis of the tax-effect accounting method, the auditor should examine whether the method has been applied properly.<sup>7</sup>

34. *Provision for Gratuity*: The auditor should examine whether the entity is required to pay gratuity to its employees by virtue of the provisions of the Payment of Gratuity Act, 1972 and/or in terms of agreement with employees and, if so, whether provision for accruing gratuity liability has been made by the entity.<sup>8</sup> The auditor should examine the adequacy of the gratuity provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine whether the method followed by it for calculating the accruing liability for gratuity is rational.

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

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

37. *Other Provisions*: Where provisions are made for liabilities that may arise on account of product warranties, service contracts, performance warranties etc., the auditor should examine

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<sup>7</sup> Reference may be made in this regard to the Accounting Standard (AS) 22, "Accounting for Taxes on Income" issued by the Institute of Chartered Accountants of India.

<sup>8</sup> Reference may be made in this regard to Accounting Standard (AS) 15 (Revised in 2005), "Accounting for Employee Benefits", issued by the Institute of Chartered Accountants of India.

whether the provisions made are in accordance with Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date", issued by the Institute of Chartered Accountants of India. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements.

### **Contingent Liabilities**

38. The term 'contingent liabilities' refers to obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. Contingent liabilities may or may not crystallize into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any legal obligation differentiates a contingent liability from a liability that has crystallized. Contingent liabilities should also be distinguished from those contingencies which are likely to result in a loss (i.e., a loss is not merely possible but probable) and which, therefore, require an adjustment of relevant assets or liabilities.<sup>9</sup> Some of the instances giving rise to contingent liabilities are:

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

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

- (a) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body.
- (b) Review of contracts, agreements and arrangements.
- (c) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.
- (d) Review of terms and conditions of grants and subsidies availed under various schemes.
- (e) Review of records relating to contingent liabilities maintained by the entity.
- (f) Enquiry of, and discussions with, the management and senior officials of the entity.
- (g) Representations from the management.

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

### **DIRECT CONFIRMATION PROCEDURE**

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

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<sup>9</sup> Reference may be made in this regard to the Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date", issued by the Institute of Chartered Accountants of India.

the creditors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

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

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

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

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

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

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

the same: degree of assurance with respect to the creditor balances. An illustrative negative form of request letter is given in **Appendix II** to this Guidance Note.

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

49. Where the number of creditors is small, all of them may be circularised, but if the creditors are numerous, this may be done on a sample basis. The sample list of creditors to be circularised, in order to be meaningful, should be based on a complete list of all creditor accounts. While selecting the creditors to be circularised, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and supplier accounts with debit balances. In addition, the auditor should select accounts in respect of which balances have been written back to the profit and loss account. In such cases, the auditor may decide that the balance as per the books of the entity may not be stated in the request letter sent to the creditors concerned; instead, the creditors may be asked to intimate the balance as per their records. The auditor may also consider including in his sample some of the accounts which have been fully squared up. The nature of the entity's business and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the creditors as a whole.

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

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

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

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

### EXAMINATION OF DISCLOSURE

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

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

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

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

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

### ANALYTICAL REVIEW PROCEDURES

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

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

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

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

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

- (a) In determining whether the loans obtained by the company are within its powers, the auditor should scrutinise its memorandum and articles of association and also examine whether the provisions of sections 292 and 293(1(d) of the Companies Act, 1956 are complied with.
- (b) The auditor should examine the register of charges to ensure that charges created have been duly registered. He should also ensure that the description of such charges disclosed in the balance sheet agrees in substance with that stated in the documents creating the charges.
- (c) The auditor should examine all loans taken from bodies corporate under the same management or from a company, firm or other party in which any director is interested and determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are *prime facie* prejudicial to the interest of the company.<sup>10</sup>
- (d) Where the company has accepted deposits, the auditor should examine compliance with the relevant legal provisions, e.g., section 58A of the Companies Act, 1956 and the rules framed thereunder/directions issued by the Reserve Bank of India.
- (e) In respect of unclaimed dividends, the auditor should examine whether the company has complied with the provisions of section 205A of the Companies Act, 1956 and the rules framed thereunder regarding transfer of certain unpaid or unclaimed dividends to a special bank account/general revenue account of the Central Government.
- (f) The auditor should examine whether any undisputed amounts payable in respect of income-tax, wealth tax, sales tax, customs duty and excise duty are outstanding as at the balance sheet date for a period of more than six months from the date they became payable. If so, the auditor should report the amounts of such outstanding dues.<sup>11</sup>
- (g) The verification procedure to be adopted by the auditor for audit of debentures would vary from year to year, depending upon whether fresh debentures are issued and/or they are redeemed or converted into shares during the year. In case of fresh issue of debentures, the auditor should examine the memorandum and articles of association of the company and resolutions authorising the issue. He should also examine compliance with the requirements of the terms of issue and any variations thereof and necessary approvals/clearances for the issue from authorities concerned such as SEBI, RBI etc. The auditor should also examine that proper accounts are maintained with regard to

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<sup>10</sup> Reference may also be made in this regard to the *Statement on the Companies (Auditor's Report) Order, 2003* issued by the Institute of Chartered Accountants of India.

<sup>11</sup> Reference may also be made in this regard to the *Statement on the Companies (Auditor's Report) Order, 2003 (Revised 2005)* issued by the Institute of Chartered Accountants of India.

amounts received towards application, allotment and calls and that the Payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where debentures are issued at a premium/discount, the auditor should ensure that such sums are accounted for distinctly. In case of buy-back, conversion, re-issue or redemption of debentures, the auditor should examine that these are in accordance with the terms of the issue. The auditor should examine that the requirements relating to creation of debenture redemption reserve and, where applicable, sinking fund and its Investment; and other related requirements are complied with.

### MANAGEMENT REPRESENTATIONS

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

### DOCUMENTATION

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

### Appendix I

#### Illustrative Letter of Confirmation to be Sent to Creditors - Positive Form

*[Ref. paragraph 46]*

[Letterhead of Entity]

[Name and Address of Creditor]

[Date]

Dear Sir,

For audit purposes, kindly confirm directly to our auditors (name and address of the auditors) that the balance of Rs. \_\_\_\_\_ due by us to you as on \_\_\_\_\_ as shown by our books, is correct. The details of the balance are as under:<sup>12</sup>

<sup>12</sup> In case the list of invoices forming the balance is too large, these details may not be given.

### III.102 Auditing Pronouncements

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Invoice No.	Date	Order Reference	Amount
		Total	_____
		Less: Payments made/other debits	_____
		Net amount due to us (Rs.)	_____

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

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

Kindly return this form in its entirety.

Yours faithfully,

(Signature of responsible official of the entity)

\_\_\_\_\_

(Do not perforate the form at this point)

[Name and Address of Entity]

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

OR

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

Invoice No.	Date	Order Reference	Amount
		Total	_____
		Less: Payments made/other debits	_____
		Net amount due to us (Rs.)	_____

Date

(Signature of creditor/responsible official)



### III.104 Auditing Pronouncements

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[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

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

1. We have recorded all known liabilities in the financial statements.
2. We have disclosed in notes to the financial statements all guarantees that we have given to third parties and all other contingent liabilities.
3. Contingent liabilities disclosed in the notes to the financial statements do not include any contingencies which are likely to result in a loss and which, therefore, require adjustment of assets or liabilities.
4. Provisions have been made in the accounts for all known losses and claims of material amounts.

Yours faithfully,

(Signature of responsible official of the entity)

## GUIDANCE NOTE ON AUDIT OF REVENUE\*

*The following is the text of the Guidance Note on Audit of Revenue issued by the Auditing Practices Committee (APC)\*\* of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)+ issued by the Institute.*

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

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

### INTRODUCTION

3. Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an entity from the sale of goods, from the rendering of services, and from the use by others of entity resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. The term 'revenue' covers only the gross inflow of cash, receivables or other consideration, as aforesaid, received or receivable by the entity on its own account. Amounts collected on behalf of third parties are excluded from revenue. For example, in an agency relationship, revenue from the view point of the agent is the amount of commission receivable by him and not the gross amount of cash, receivables or other consideration collected by him on behalf of the principal.

\* Published in May, 1997 issue of 'The Chartered Accountant'.

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

+ Now known as the Engagement Standards.

<sup>1</sup> The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.

<sup>2</sup> Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

### III.106 Auditing Pronouncements

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

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

5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard on Auditing (SA) 500, *Audit Evidence*). In carrying out an audit of revenue, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

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

#### INTERNAL CONTROL EVALUATION

6. The auditor should study and evaluate the system of internal control relating to revenue, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to revenue:<sup>3</sup>

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

#### VERIFICATION

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

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

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

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

### EXAMINATION OF RECORDS

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

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

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

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

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

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

14. In respect of sales to intermediate parties (i.e., where goods are sold to distributors, dealers or others for resale), the auditor should examine that revenue from such sales is not recognised until the significant risks and rewards of ownership have passed. However, in situations where an intermediate party is in substance an agent (e.g., a consignee), revenue should not be recognised until the related goods are sold to a third party.<sup>4</sup>

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<sup>4</sup> Reference may be made to AS 1, *Disclosure of Accounting Policies*, for discussion on the concept of "substance over form".

### III.108 Auditing Pronouncements

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

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

- (a) The auditor should examine that revenue from export sales in which consideration is receivable in a foreign currency is recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*<sup>5</sup>.
- (b) The auditor should obtain a written representation from the management to the effect that the entity has complied with the legal and regulatory requirements relating to exports.<sup>6</sup>

17. In respect of revenue arising from services rendered (i.e., in the form of fees, commission, brokerage, etc.), the auditor should examine the related agreements and other documents. Similarly, in respect of revenue in the form of interest, dividends and royalties, the auditor should examine the related documents such as loan documents, lease agreements, etc. The auditor may also seek confirmatory certificates from the parties concerned.

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

#### EXAMINATION OF PRESENTATION AND DISCLOSURE

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

#### ANALYTICAL PROCEDURES

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

- (a) Comparison, product-wise and location-wise, of revenue for the current year with the corresponding figures for previous years.
- (b) Comparison of ratio of gross margin to sales for the current year with the corresponding figures for previous years.
- (c) Comparison of ratio of sales returns to sales for the current year with the corresponding figures for previous years.
- (d) Comparison of ratio of trade discount to sales for the current year with the corresponding figures for previous years.

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<sup>5</sup> This Accounting Standard has been revised in 2003. The title of the revised Accounting Standard is "Effects of Changes in Foreign Exchange Rates".

<sup>6</sup> Reference may be made in this regard to SA 580, "Representations by Management".

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

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

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

#### **SPECIAL CONSIDERATIONS IN THE CASE OF A COMPANY**

21. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. For example, as required by the [Manufacturing and Other Companies (Auditor's Report) Order, 1988, issued under section 227(4A) of the Act, the auditor should examine whether the transactions of sale of goods, materials and services and purchase of goods and materials, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Act, and exceeding the limits specified in the Order, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials or services or the price at which transactions for similar goods or services have been made with other parties.<sup>7</sup>]

#### **DOCUMENTATION**

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

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<sup>7</sup> Reference may be made in this regard to Statement on Companies (Auditor's Report) Order, 2003 (Revised 2005).

## GUIDANCE NOTE ON AUDIT OF EXPENSES\*

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

The Auditing Practices Committee<sup>\*\*\*</sup> has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Expenses, paragraphs 11.2-11.8 of Chapter 11 of the *Statement on Auditing Practices*, titled 'Profit and Loss Account', shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.<sup>2</sup>

The following is the text of the Guidance Note on "Audit of Expenses" issued by the Auditing Practices Committee of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices issued by the Institute.

### INTRODUCTION

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

2. *Expenses are recognised by the following approaches:*

(a) *Identification with revenue transactions*

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<sup>\*</sup> Published in November, 2001 issue of 'The Chartered Accountant'.

<sup>1</sup> The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.I of this Handbook.

<sup>\*\*</sup> Now known as Engagement Standards.

<sup>\*\*\*</sup> Now known as Auditing and Assurance Standards Board.

<sup>2</sup> Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

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

(b) *Identification with a period of time*

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time.<sup>3</sup> Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g., salaries, telephone, travelling, depreciation on office building, normal interest, etc. Similarly, the costs, the benefits of which, do not clearly extend beyond the accounting period are also charged as expenses.

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

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

4. In an audit, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see SA 500, *Audit Evidence*). In carrying out an audit of expenses, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

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<sup>3</sup> Reference may be made in this regard to Guidance Note on Accrual Basis of Accounting.

### III.112 Auditing Pronouncements

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Occurrence	that recorded expenses arose from transactions or events that place during the relevant period and pertain to the entity.
Completeness	that there are no unrecorded expenses.
Measurement	that expenses are recorded in the proper amounts and are allocated to the proper period.
Presentation and Disclosure	that expenses are disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

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

#### INTERNAL CONTROL EVALUATION

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

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

#### VERIFICATION

7. Verification of expenses may be carried out by employing the procedures, *viz.*, (a) examination of records; and (b) analytical procedures. The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls. The auditor should examine whether the basis of recognition of expenses by the entity is in accordance with the recognised accounting principles.

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

**(a) Examination of Records**

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

**(b) Analytical Procedures**

9. The auditor should conduct analytical procedures which involve analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.<sup>5</sup>

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

**GOODS AND RAW MATERIALS CONSUMED**

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

**PURCHASES AND PURCHASE RETURNS**

12. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to purchases and purchase returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the selected receipt documents (such as goods received notes) pertaining to a few days immediately before the year-end and verify that the related purchase invoices have been recorded as purchases of the current year. The auditor should pay particular attention to the cut-off procedures relating to purchases, both indigenous and imported, to determine whether these procedures ensure recognition of purchases at the time the significant risks and rewards of ownership of the related goods pass on to the entity.

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

14. While examining purchase invoices, the auditor should examine whether subsidies, rebates, duty drawbacks or other similar items have been properly accounted for. As per AS 2, costs of purchase consist of the purchase price including duties and taxes (other than those

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<sup>5</sup> Refer to Standard on Auditing (SA) 520, "Analytical Procedures".

### III.114 Auditing Pronouncements

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subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

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

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

17. In case of transactions between related parties, the auditor should pay special attention to nature and description of such transactions.<sup>6</sup>

18. The auditor should obtain a representation from the management to the effect that the entity has complied with the legal and regulatory requirements, if any. When the auditor becomes aware of non-compliance, the auditor should obtain sufficient information to evaluate the possible effect in the financial statements. The auditor should also consider communication/reporting of non-compliance with the management including audit committee, users of financial statements and to regulatory authorities, as may be appropriate.<sup>7</sup>

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

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

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

- (a) Comparison, item-wise and location-wise, both quantity and value, of purchases for the current year/period with the corresponding figures for previous years/periods.
- (b) Comparison of ratio of gross margin to sales for the current year/period with the corresponding figures for previous years/periods.

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<sup>6</sup> Refer to Accounting Standard (AS) 18, "Related Party Disclosures".

<sup>7</sup> Refer to Standard on Auditing (SA) 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

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

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

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

#### **Wages and Salaries**

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

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

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

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

### III.116 Auditing Pronouncements

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

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

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

#### **Bonus**

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

#### **Retirement Benefits**

29. The auditor should examine whether the entity is liable to pay any retirement benefits to its employees such as provident fund, superannuation/pension, gratuity, etc., whether in pursuance of requirements of any law and/or in terms of agreement with the employees<sup>8</sup>. If so, the auditor should examine whether the amount payable has been computed in accordance

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<sup>8</sup> Attention is invited in this regard to Accounting Standard (AS) 15, "Accounting for Employees Benefits".

with the relevant legal and/or contractual requirements. In respect of gratuity/pension, the auditor should specifically examine whether the provision for accruing gratuity/pension liability has been made by the entity. The auditor should examine the adequacy of provision with reference to the actuarial certificate obtained by the entity<sup>9</sup>. In case the entity has not obtained such an actuarial certificate, the auditor should examine that the method followed by it, say, group gratuity insurance scheme taken by the entity, for calculating the accrued liability for gratuity is rational.

#### **Other Conversion Costs**

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

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

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

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

32. The auditor should verify the amount of interest expense for the year with reference to the terms and conditions of relevant agreements. The auditor may also work out the ratio of interest expense for the year to average interest-bearing loans and advances outstanding during the year and compare it with the corresponding figure for previous years and reconcile the same. The auditor should particularly examine that interest as well as other financing costs such as commitment fees on funds borrowed for a qualifying asset included in the gross book value of the asset to which they relate and have not been charged to the Profit and Loss Account of the period in which they are incurred<sup>10</sup>. If the entity has paid any penal interest, it should also be examined. Such interest should be disclosed as part of normal interest. The auditor should consider, having regard to the materiality, whether it requires separate disclosure.

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<sup>9</sup>Attention is also invited in this regard to Standard on Auditing (SA) 620, "Using the Work of an Expert".

<sup>10</sup> Attention is invited in this regard to Accounting Standard (AS) 16, "Borrowing Costs".

### DEPRECIATION

33. The auditor should check the calculation of depreciation. The total depreciation arrived at should be compared with that of previous years to identify reasons for variations. The auditor should particularly examine whether the depreciation charge having regard to rate of depreciation and method of depreciation followed consistently is adequate keeping in view the generally accepted bases of accounting for depreciation<sup>11</sup>. Alternatively, the auditor may consider qualifying his report. In case, assets have been revalued by entity during the year, the auditor should ensure that the depreciation has been computed properly.

### RESEARCH AND DEVELOPMENT EXPENSES

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

35. The auditor should examine whether the deferral meets the appropriate legal requirements, if any. If an accounting policy for deferral of research and developments is adopted, it should be applied to all such projects which meet the criteria laid down for deferral under AS 8. The auditor should examine whether the criteria laid down in AS 8 which previously justified the deferral of certain research and development costs no longer apply, the unamortised balance has been charged as an expense of the year. Similarly, the auditor should examine that where the criteria for deferral continue to be met but the amount of unamortised balance of the deferred research and development costs and other relevant costs exceed the expected future revenues/benefits related thereto, such excess has been charged as an expense immediately.

### REPAIRS AND MAINTENANCE

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

### CONTINGENCIES

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

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<sup>11</sup> Attention is also drawn to Accounting Standard (AS) 6, "Depreciation Accounting".

## TAXES ON INCOME

38. The auditor should examine that tax expense or tax saving has been properly computed and disclosed in the financial statements<sup>12</sup>. The tax expense for the period which comprises current tax and deferred tax is to be included in the determination of net profit or loss for the period under audit. In case of companies attracting minimum alternate tax, it has to be ensured that proper provision has been considered in the accounts. The auditor should examine that the deferred taxes have been recognised for all timing differences subject to consideration of prudence in respect of deferred tax assets as set out in Accounting Standard (AS) 22, *Accounting for Taxes on Income*. If there is a material departure from the provisions of AS 22, the auditor should qualify his report.

39. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether adjustment is required in the financial statements.

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

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

## SPECIAL CONSIDERATIONS IN THE CASE OF A COMPANY

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

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<sup>12</sup> Attention is drawn to Accounting Standard (AS) 22, "Accounting for Taxes on Income".

### III.120 Auditing Pronouncements

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- (a) The auditor should examine whether the managerial remuneration paid or payable by the company is within the limits laid down under section 198 and Schedule XIII to the Companies Act, 1956. The auditor should also examine whether the remuneration paid or payable to the directors of the company, including any managing or whole-time director, has been determined by the Articles of Association of the company or by a resolution of the company passed in a general meeting. The auditor should also examine whether the remuneration of directors complies with the provisions of section 309 of the Companies Act, 1956. The auditor should further examine whether the computation of net profit for purposes of managerial remuneration is in accordance with sections 349 and 350 of the Companies Act, 1956.
- (b) The auditor should examine whether the contributions, if any, made by the company to charitable and other funds not directly relating to the business of the company or the welfare of its employees comply with the provisions of section 293 of the Companies Act, 1956. According to this section, the board of directors of a public company cannot, except with the consent of the company in general meeting, contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed Rs.50,000 or 5 per cent of the average net profits of the company as determined in accordance with the provisions of section 349 and section 350 during the three financial years immediately preceding, whichever is greater. The auditor should examine whether the Memorandum of Association of the company empowers it to make contributions to charitable or other funds not directly relating to the business of the company or the welfare of its employees. If the objects clause in the Memorandum does not contain such authority, the company has no power to make such contributions.

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

- (c) The auditor should examine whether political contributions made by the company are within the limit prescribed in section 293A of the Companies Act, 1956.<sup>13</sup> Where the limit laid down under section 293A is adhered to and the facts are properly disclosed, the auditor has no further duty. Where, however, the facts regarding such contributions are not properly disclosed, the auditor should qualify his report and state the facts therein. Where the auditor has genuine doubt regarding the applicability of the Section, he should ensure that the fact is properly disclosed in his audit report.

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

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<sup>13</sup> Reference may be made in this regard to the Guidance Note on Section 293A of the Companies Act, 1956 and the Auditor.

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

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

- (d) The auditor should examine whether the contribution, if any, to the National Defence Fund or any other fund approved by the Central Government for the purpose of national defence complies with the provisions of section 293B of the Companies Act, 1956. This section empowers the board of directors to make such contributions. It may be noted that unlike the contributions to charitable or other funds not directly relating to the business of the company or to the welfare of its employees, contributions to National Defence Fund (or other similar funds) can be made by a company even where the Memorandum of Association of the company does not specifically empower it in this regard. The auditor should examine whether the total amount or amounts contributed by the company to the National Defence Fund (or other similar funds) during the year have been suitably disclosed in the profit and loss account.
- (e) In respect of payments to sole-selling agents, the auditor should examine whether the provisions of sections 294, 294A and 294AA have been complied with.
- (f) The auditor should examine whether the provisions of section 297 have been complied with in appropriate cases. He should also examine compliance with the terms and conditions, if any, stipulated by the Central Government in its approval under the proviso to sub-section (1) of section 297.
- (g) In case any partner or relative of a director of the company, any firm in which such director, or relative of such director, is a partner, any private company of which such director is a director or member, or any director, or manager of such a private company, holds any office or place of profit under the company or under any subsidiary of the company, the auditor should examine whether the provisions of section 314 have been complied with.
- (h) The auditor should examine whether any personal expenses have been charged to revenue account.
- (i) The auditor should examine whether the transaction of purchase of goods and materials and services, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Companies Act, 1956, as aggregating during the year to Rs.50,000<sup>@</sup> (Rupees Fifty Thousand) or more in respect of each party, have been made at prices which are reasonable having regard to prevailing market prices for such

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

### III.122 Auditing Pronouncements

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goods, materials and services or the prices at which transaction for similar goods or service have been made with other parties.<sup>14</sup>

- (j) The auditor should examine whether any undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding as at the last day of financial year concerned, for a period of more than six months from the date they became payable have been reported under MAOCARO, 1988<sup>@@</sup>.

#### EXAMINATION OF PRESENTATION AND DISCLOSURE

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

#### MANAGEMENT REPRESENTATION

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

#### DOCUMENTATION

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

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<sup>14</sup> Reference may be made in this regard to the Statement on the Companies (Auditor's Report) Order, 2003 (Revised in 2005).

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

<sup>15</sup> Reference may be made in this regard to Standard on Auditing (SA) 580, "Representation by Management".

<sup>16</sup> Reference may be made in this regard to Standard on Auditing (SA) 230, "Documentation".

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## GUIDANCE NOTE ON SECTION 227(3)(e) AND (f) OF THE COMPANIES ACT, 1956 [REVISED]\*

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### INTRODUCTION

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

- "(3) The auditor's report shall also state -
- (a) whether he has obtained all the information and explanations, which to the best of his knowledge and belief, were necessary for the purposes of his audit;
  - (b) whether, in his opinion, proper books of account, as required by law, have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
  - (bb) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (c) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor's report;
  - (c) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns;
  - (d) whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;
  - (e) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company;

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\* Issued in March, 2001.

### III.124 Auditing Pronouncements

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

#### SCOPE OF THE GUIDANCE NOTE

5. This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (e) and (f) of sub-section (3) of section 227 of the Act. Clause (e) of the

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

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

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

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

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

.....

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

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

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

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

does not intend to change the basic objective and the concept of audit of financial statements of a company, which is to examine the financial statements with a view to express an opinion thereon.

9. The scope of the audit and auditor's role remains as contemplated under the Engagement Standards and other relevant pronouncements issued by the Institute of Chartered Accountants of India as well as laid down in the Act, i.e., to lend credibility to the financial statements by reporting whether they reflect a true and fair view. SA 200A, "Objective and Scope of the Audit of Financial Statements" specifies, "the auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise". It also states, "the auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements. Furthermore, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. Because of these factors, absolute certainty in auditing is rarely attainable". Further, it also clarifies that "in forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery".

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

11. As far as inquiries under section 227(1A) are concerned, the auditor is not required to report on these matters unless he has any special comments to make on any of the items referred to therein. The auditor may also consider highlighting such comments in **thick** type or in *italics* which have any adverse effect on the functioning of the company. Another issue which arises is whether any observation or comment made by the auditor in respect of his statements on matters specified in CARO, 2003 issued under section 227(4A) of the Act, which has any adverse effect on the functioning of the company, should also be reported in terms of this clause. In this regard, it is noted that section 227(4A) of the Act treats the comments on the matters specified in CARO, 2003 as a part of the auditor's report. Accordingly, any observation or comment made by the auditor in his report under CARO, 2003 contain such matters, which, in his opinion, will have any adverse effect on the functioning of the company, should also be reported in **thick** type or *italics* as required by this clause. An example in this regard may be where an auditor in respect of paragraph 4(i)(c) of CARO, 2003 reports that there exists a substantial doubt that without the replacement of significant part of fixed assets sold during the year, the company would be able to continue as a going concern for the foreseeable future.

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

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

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

.....  
 .....

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

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

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

.....  
 .....

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

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

*(B) has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more;*

*Provided that such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public*

*company in which he is a director failed to file annual accounts and annual returns under sub-clause (a) or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in clause (B)."*

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

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

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

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

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

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

continues to be a public limited company under the Act and therefore the Rules would be applicable to such a public limited company.

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

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

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

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

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

- (a) The person is a director in a public company as on the last due date for filing the annual accounts and annual return for three continuous financial years. Thus, even if the person concerned has been appointed as a director in the public company only a few days before the last due date, the person would attract disqualification under section 274(1)(g). Further, a person who ceased to be a director of the public company as on the last due date for filing the annual accounts and annual return for three continuous financial years would not be disqualified from being appointed as a director of a public company.

### III.130 Auditing Pronouncements

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- (b) The public company has not filed the annual accounts and annual return for three consecutive financial years. Thus, if the said failure is not for a period of three continuous financial years, the disqualification would not be attracted.
- (c) The public company has failed to file both, the annual accounts and annual return. Thus, if the company has filed either the annual accounts or annual return within the due dates, the disqualification would not be attracted.
- (d) The period of five years has not elapsed since the date of default made by the public company. Thus, if the period of five years has elapsed since the date of the default, the person concerned shall not remain disqualified under sub-clause (A) of section 274(1)(g).

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

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

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

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

- (i) In respect of sub clause (B) of clause (g) of section 274(1) of the Act, the Department, vide its general circular numbered 5 of 2003 (F No. 2/5/2001-CLV) dated 14-1-2003 has clarified that default in repayment of privately placed bonds/ debentures/ debt instruments by public financial institutions will not be considered as default to disqualify directors under section 274(1)(g) of the Act.

- (ii) The Department has, vide its notification numbered GSR 829(E), also clarified that the provisions of clause (g) of sub section (1) of section 274 of the Act shall not be applicable to a Government company.
- (iii) Further, the Department has also clarified, vide its general circular numbered 8/2002, dated 22-3-2002, that the nominee directors appointed by the public financial institutions and companies established under the Act of Parliament having non obstante provisions over the Companies Act, 1956 like IDBI, LIC, UTI, IIBI, etc., in their respective statutes shall not be liable to be disqualified under section 274(1)(g) of the Act. The Department has also clarified that the nominee directors appointed on the boards of assisted concerns or other public companies by (a) public financial institutions within the meaning of section 4A of the Act; (b) Central or State Government; and (c) banking companies are also exempt from the provisions of section 274(1)(g) of the Act.

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

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

27. Under Rule 9, every director in a public company registered under the Companies Act, 1956, is required to file Form DD-A, as prescribed in the Rules, before he is appointed or reappointed in any company. Rule 5 also casts a duty on every company which has failed to file its annual accounts and returns and/or fails to repay any deposit, interest, dividend, or fails

### III.132 Auditing Pronouncements

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to redeem its debentures, as described in clauses (A) and (B) of clause (g) of sub-section (1) of section 274 of the Act, to immediately file a return in duplicate in Form DD-B (prescribed in the said Rules) with the Registrar of Companies.

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

#### DUTIES OF THE AUDITOR UNDER THE RULES

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

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

30. It is, therefore, clear that the statutory auditors of both the disqualifying as well as the appointing company would, in addition to their report in terms of section 227(3)(f) of the Act, would also have to, each financial year, furnish a certificate as required in Rule 4.

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

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

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

- (a) Names of directors of the company during the period covered by the auditor's report (including the directors at the balance sheet date), showing separately, the names of

nominee directors and directors appointed in accordance with the Companies (Appointment of the Small Shareholders' Director) Rules, 2001

- (b) Particulars of appointment/reappointment, resignation/retirement etc., of each of the above directors.
- (c) Whether in case of directors appointed on or after the date of the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 coming into effect, each such director has submitted Form DD-A, as required under the said Rules.
- (d) That the information contained in the register of directors maintained under section 303(1) is updated to show the position as on the balance sheet date.
- (e) Whether the company has committed any default as envisaged in sub-clauses (A) and/or (B) of clause (g) of section 274 (1) of the Act.
- (f) In case the company has committed a default under sub-clauses (A) and/ or (B) of clause (g) of section 274(1) of the Act, whether the company has furnished the Form DD-B, as required by the Rules.

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

34. The auditor should verify the information provided by the management and the directors from the information contained in the register maintained under section 303(1) of the Act. The said register contains various particulars relating to all the directors of the company including

particulars in respect of the office of director, managing director, etc. The auditor can also examine the Form 32 filed by the company during the financial year under section 303(2) of the Act so as to know the changes, for example, appointment, retirement, resignation etc., of directors during the year. Form DD-A filed by the directors would also assist the auditor in assessing whether any director appointed during the year, at the time of appointed, was disqualified under section 274(1)(g) of the Act.

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

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

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

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

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

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

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

- (c) Where on the basis of the written representation received from a director, it is noted that the director was disqualified from being appointed as a director under this clause, the auditor may report as follows:

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

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

#### Certificate under the Rules

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

#### Appendix I

PUBLISHED IN THE GAZETTE OF INDIA, PART II, SECTION 3(i), EXTRAORDINARY

*Ministry of Finance*

(Department of Company Affairs)

NOTIFICATION

New Delhi, the 21<sup>st</sup> October, 2003

**G.S.R. 830 (E).**- In exercise of the powers conferred by clause (b) of sub-section (1) of section 642 of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following rules to carry out the purpose of clause (g) of sub-section (1) of section 274 of the said Act, namely :-

#### 1. Short Title, Commencement and Extent

- (1) These rules may be called the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003.

### III.136 Auditing Pronouncements

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- (2) These rules shall come into force from the date of their notification in the Official Gazette.
- (3) These rules shall apply to all public limited companies registered under the Companies Act, 1956.

#### 2. Definitions

In these Rules, unless the context otherwise requires, -

- (a) "disqualifying company" is the company in which the default has occurred on account of which a director stands disqualified;
- (b) "appointing company" is the company in which an individual is seeking appointment as a director, including re-appointment as director.

#### 3. Disqualifications under clause (g) of sub-section (1) of section 274 of the Companies Act, 1956

- (a) Whenever a company fails to file the annual accounts and annual returns, as described in sub-clause (A) of clause (g) of sub-section (1) of section 274, persons who are directors on the last due date for filing the annual accounts and the annual returns for any continuous three financial years commencing on and after the first day of April, 1999, shall be disqualified.
- (b) If a company has failed to repay any deposit, irrespective of the enactment, rules or regulations under which the deposits have been accepted by the companies, or interest thereon, or redeem its debentures, or pay any dividend declared on the respective due dates, and if such failure continues for one year, as described in sub-clause (B) of clause (g) of sub-section (1) of section 274, then the directors of that company shall stand disqualified immediately on expiry of that one year from the respective due dates:

Provided that all the directors who have been directors in the relevant year, from the due date to the expiry of one year after the due date, will be disqualified:

Provided further that disqualification on account of the reasons cited under this Rule shall also apply to the reappointment as a director.

*Explanation*-For the purpose of this rule, it is clarified that non-payment of dividend referred to in sub-clause (B) of clause (g) of sub-section (1) of section 274 due to the reason of dividend not being claimed or kept in separate bank account as required under section 205A of Companies Act, 1956 or paid into Investors Education & Protection Fund as required under section 205C of that Act shall not be deemed to be a failure to make payment of dividend.

#### 4. Duty of Statutory Auditor to Report on Disqualification

- (a) It shall be the duty of statutory auditor of the appointing company as well as disqualifying company, as required under section 227(3)(f) to report to the members of the company whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274 and to furnish a certificate each year as to whether on the

basis of his examination of the books and records of the company, any director of the company is disqualified for appointment as a director or not.

- (b) It shall be the duty of the statutory auditors of the "disqualifying company" as required in section 227(3)(f) to report to the members of the company whether any director in the company has been disqualified during the year from being re-appointed as director, or being appointed as director in another company under clause (g), of sub-section (1) of section 274.

#### **5. Duty of Company to Intimate Disqualification**

Whenever a company fails to file the annual accounts and returns, or fails to repay any deposit, interest, dividend, or fails to redeem its debentures, as described in clauses (A) and (B) of clause (g) of sub-section (1) of section 274, the company shall immediately file a return in duplicate in Form 'DD-B', prescribed under these rules for this purpose, to the Registrar of Companies, furnishing therein the names and addresses of all the Directors of the company during the relevant financial years:

Provided that names of such directors who have been exempted from application of Section 274(1)(g) by the Central Government, from time to time, shall be excluded.

Provided further that no unusual abbreviations or short forms shall be used in filling up the Form 'DD-B', which shall give such details as may be necessary to distinguish and identify each director without any ambiguity.

#### **6. Failure to Intimate Disqualification Shall render Director as Officer in Default**

When a company fails to file the Form 'DD-B' as above within 30 days of the failure that would attract disqualification under Section 274(1)(g), officers of the company listed in section 5 of the Companies Act, 1956 shall be officers in default.

- 7.(a) Upon receipt of the Form 'DD-B' in duplicate under Rule 5, the Registrar of Companies shall immediately register the document and place one copy of it in the document file for public inspection.
- (b) The Registrar of Companies shall forward the other copy to the Central Government.

#### **8. Names of the Disqualified Directors on the Website etc.**

- (a) The Central Government shall place on the web site of the Department of Company Affairs the names and addresses and such other details including names and details of the companies concerned, as may be necessary, in respect of all the disqualified directors.
- (b) The Central Government may also publicize the names of disqualified directors in such manner as it may consider appropriate.
- (c) The Central Government shall take such steps as may be required to update its web-site to ensure that name of the person, in whose respect disqualification period has expired after 5 years, is deleted from the web-site.

**9. Duty of Every Director**

Every director in a public company registered under the Companies Act, 1956 shall file Form 'DD-A', prescribed under these Rules, before he is appointed or re-appointed.

10. If any question arises as to whether these rules are or are not applicable to a particular company, such question shall be decided by the Central Government.

**11. Punishment for Contravention of the Rules**

If a company or any other person contravenes any provision of these rules for which no punishment is provided in the Companies Act, 1956, the company and every officer of the company who is in default or such other person shall be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first, during which the contravention continues.

12. On the commencement of these rules, all rules, orders or directions in force in relation to any matter for which provision is made in these Rules shall stand repealed, except as respects things done or omitted to be done before such repeal.

[F. No.1/8/2002-CL.V]

Rajiv Mehrishi,  
Joint Secretary

**FORM 'DD-A'**

**Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003**

Intimation by Director

[Pursuant to Section 274(1)(g)]

Registration No. of Company \_\_\_\_\_

Nominal Capital Rs. \_\_\_\_\_

Paid-up Capital Rs. \_\_\_\_\_

Name of Company \_\_\_\_\_

Address of its Registered Office \_\_\_\_\_

To

The Board of Directors

of \_\_\_\_\_

I \_\_\_\_\_ son/daughter/wife of \_\_\_\_\_ resident of \_\_\_\_\_ director/managing director/manager in the company hereby give notice that I am/was a director in the following companies during the last 3 years:

Name of the Company	Date of Appointment	Date of Cessation
1.....		
2.....		

I further confirm that I have not incurred disqualification under section 274(1)(g) of the Companies Act, 1956 in any of the above companies, in the previous financial year, and that I, at present, stand free from any disqualification from being a director.

or

I further confirm that I have incurred disqualifications under section 274(1)(g) of the Companies Act, 1956 in the following company(s) in the previous financial year, and that I, at present stand disqualified from being a director.

Name of the Company	Date of Appointment	Date of Cessation
1.....		
2.....		

Signature  
(Full Name)

Dated this \_\_\_\_\_ day of \_\_\_\_\_

**FORM 'DD-B'**  
**Report by a Public Company**

[Pursuant to Section 274(1)(g) read with Rule 5 of Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003]

Registration No. of Company: \_\_\_\_\_

Nominal Capital Rs. \_\_\_\_\_

Paid-up Capital Rs. \_\_\_\_\_

Name of Company \_\_\_\_\_

Address of its Registered Office \_\_\_\_\_

To

The Registrar of Companies,

It is hereby reported under section 274(1)(g) of Companies Act, 1956, that M/s. \_\_\_\_\_ have failed to (i) file the annual accounts and annual returns for the last three financial years, or (ii) repay deposits or interest thereon on due date being \_\_\_\_\_ or redeem its debentures on due date being \_\_\_\_\_ or pay dividend declared by the company since \_\_\_\_\_ or both. The period of one year has expired on \_\_\_\_\_.

### III.140 Auditing Pronouncements

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The name and address of directors at the relevant period are as under :-

- (a) Director's name in full, without abbreviations
- (b) Director's name as per company's records (abbreviations may be expanded and shown)
- (c) Address of the Director
  - (i) Permanent
  - (ii) Present
- (d) Positions held by the director in the last 5 years, prior to disqualification:

Signature  
Designation\*

Dated this \_\_\_\_\_ day of \_\_\_\_\_

\*State whether Director, Managing Director, Manager or Secretary

#### Appendix II

#### FORMAT OF THE CERTIFICATE TO BE ISSUED UNDER RULE 4 (a) OF THE COMPANIES (DISQUALIFICATION OF DIRECTORS UNDER SECTION 274(1)(g) OF THE COMPANIES ACT, 1956) RULES, 2003

##### Auditor's Certificate

##### Rule 4 (a) of the Companies (Disqualification of Directors Under section 274(1)(g) of the Companies Act, 1956) Rules, 2003

To,

The Board of Directors of \_\_\_\_\_ (name of the company)

In terms of Rule 4(a) of the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003, I/we ..... (name of the chartered accountant/ firm, as the case may be), based on our examination of the books and records of the company, carried out in accordance with the requirements of the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956, issued by the Institute of Chartered Accountants of India, do hereby certify that none of the directors of the company, i.e., ..... (name of the company) as on \_\_\_\_\_ (date of the balance sheet) is disqualified for appointment as a director in the aforementioned company in terms of clause (g) of sub section (1) of section 274 of the Companies Act, 1956.

Date:

For XYZ & Co.,  
Chartered Accountants

Address:

.....  
(Signature)  
(Name of the Member Signing the Certificate)  
(Designation<sup>4</sup>)  
.....  
(Membership Number)

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<sup>4</sup> Partner or proprietor, as the case may be.

## **GUIDANCE NOTE ON COMPUTER ASSISTED AUDIT TECHNIQUES (CAATs)\***

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### **INTRODUCTION**

1. The overall objectives and scope of an audit do not change when an audit is conducted in a computer information systems (CIS) environment. The application of auditing procedures may, however, require the auditor to consider techniques known as Computer Assisted Audit Techniques (CAATs) that use the computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance, contained in an entity's information systems.

2. The purpose of this Guidance Note is to provide guidance in the use of CAATs. This Guidance Note describes computer assisted audit techniques including computer tools, collectively referred to as CAATs. This Guidance Note applies to all uses of CAATs when a computer of any type or size is involved whether that computer is operated by the entity or by a third party.

### **DESCRIPTION OF COMPUTER ASSISTED AUDIT TECHNIQUES (CAATS)**

3. Computer Assisted Audit Techniques (CAATs) are important tools for the auditor in performing audits. CAATs may be used in performing various auditing procedures, including the following:

- ◆ tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;
- ◆ analytical procedures, for example, identifying inconsistencies or significant fluctuations;
- ◆ tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management ;
- ◆ sampling programs to extract data for audit testing;
- ◆ tests of application controls, for example, testing the functioning of a programmed control; and
- ◆ reperforming calculations performed by the entity's accounting systems.

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\* Issued in September, 2003

4. CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software, and perform audit tests more efficiently. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance contained in an entity's information systems. CAATs may consist of package programs, purpose-written programs, utility programs or system management program. Regardless of the origin of the programs, the auditor substantiates their appropriateness and validity for audit purposes before using them. A brief description of the programs commonly used is given below.

- ◆ *Package Programs* are generalized computer programs designed to perform data processing functions, such as reading data, selecting and analyzing information, performing calculations, creating data files and reporting in a format specified by the auditor.
- ◆ *Purpose-Written Programs* perform audit tasks in specific circumstances. These programs may be developed by the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor may use an entity's existing programs in their original or modified state because it may be more efficient than developing independent programs.
- ◆ *Utility Programs* are used by an entity to perform common data processing functions, such as sorting, creating and printing files. These programs are generally not designed for audit purposes, and therefore may not contain features such as automatic record counts or control totals.
- ◆ *System Management Programs* are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software. As with utility programs these tools are not specifically designed for auditing use and their use requires additional care.

Details of some of the techniques used are mentioned in the Appendix.

#### CONSIDERATIONS IN THE USE OF CAATS

5. When planning an audit, the auditor may consider an appropriate combination of manual and computer assisted audit techniques. In determining whether to use CAATs, the factors to consider include:

- ◆ the IT knowledge, expertise and experience of the audit team;
- ◆ the availability of CAATs and suitable computer facilities and data;
- ◆ the impracticability of manual tests;
- ◆ effectiveness and efficiency; and
- ◆ time constraints.

Before using CAATs the auditor considers the controls incorporated in the design of the entity's computer systems to which CAAT would be applied in order to determine whether, and if so, how, CAATs should be used.

#### **IT KNOWLEDGE, EXPERTISE AND EXPERIENCE OF THE AUDIT TEAM**

6. Standard on Auditing (SA) 401, "Auditing in a Computer Information Systems Environment" deals with the level of skill and competence the audit team needs to conduct an audit in a CIS environment. It provides guidance when an auditor delegates work to assistants with CIS skills or when the auditor uses work performed by other auditors or experts with such skills. Specifically, the audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted. The level of knowledge required depends on "availability of CAATs" and "suitable computer facilities".

#### **AVAILABILITY OF CAATS AND SUITABLE COMPUTER FACILITIES**

7. The auditor considers the availability of CAATs, suitable computer facilities and the necessary computer-based information systems and data. The auditor may plan to use other computer facilities when the use of CAATs on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package program and entity's computer. Additionally, the auditor may elect to use their own facilities, such as PCs or laptops.

8. The cooperation of the entity's personnel may be required to provide processing facilities at a convenient time, to assist with activities such as loading and running of CAAT on the entity's system, and to provide copies of data files in the format required by the auditor.

#### **IMPRACTICABILITY OF MANUAL TESTS**

9. Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve amounts of data that would overwhelm any manual procedure. In addition, many computer information systems perform tasks for which no hard copy evidence is available and, therefore, it may be impracticable for the auditor to perform tests manually. The lack of hard copy evidence may occur at different stages in the business cycle.

- ◆ Source information may be initiated electronically, such as by voice activation, electronic data imaging, or point of sale electronic funds transfer. In addition, some transactions, such as discounts and interest calculations, may be generated directly by computer programs with no specific authorization of individual transactions.
- ◆ A system may not produce a visible audit trail providing assurance as to the completeness and accuracy of transactions processed. For example, a computer program might match delivery notes and suppliers' invoices.
- ◆ In addition, programmed controlled procedures, such as checking customer credit limits, may provide hard copy evidence only on an exception basis.
- ◆ A system may not produce hard copy reports. In addition, a printed report may contain only summary totals while computer files retain the supporting details.

### EFFECTIVENESS AND EFFICIENCY

10. The effectiveness and efficiency of auditing procedures may be improved by using CAATs to obtain and evaluate audit evidence. CAATs are often an efficient means of testing a large number of transactions or controls over large populations by:

- ◆ analyzing and selecting samples from a large volume of transactions;
- ◆ applying analytical procedures; and
- ◆ performing substantive procedures.

11. Matters relating to efficiency that an auditor might consider include:

- ◆ the time taken to plan, design, execute and evaluate CAAT;
- ◆ technical review and assistance hours;
- ◆ designing and printing of forms (for example, confirmations); and
- ◆ availability of computer resources

12. In evaluating the effectiveness and efficiency of CAAT, the auditor considers the continuing use of CAAT application. The initial planning, design and development of CAAT will usually benefit audits in subsequent periods.

### TIME CONSTRAINTS

13. Certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.

14. Where the time available to perform an audit is limited, the auditor may plan to use CAAT because its use will meet the auditor's time requirement better than other possible procedures.

### USING CAATS

15. The major steps to be undertaken by the auditor in the application of CAAT are to:

- (a) set the objective of CAAT application;
- (b) determine the content and accessibility of the entity's files;
- (c) identify the specific files or databases to be examined;
- (d) understand the relationship between the data tables where a database is to be examined;
- (e) define the specific tests or procedures and related transactions and balances affected;
- (f) define the output requirements;
- (g) arrange with the user and IT departments, if appropriate, for copies of the relevant files or database tables to be made at the appropriate cut off date and time;
- (h) identify the personnel who may participate in the design and application of CAAT;

- (i) refine the estimates of costs and benefits;
- (j) ensure that the use of CAAT is properly controlled;
- (k) arrange the administrative activities, including the necessary skills and computer facilities;
- (l) reconcile data to be used for CAAT with the accounting and other records;
- (m) execute CAAT application;
- (n) evaluate the results;
- (o) document CAATs to be used including objectives, high level flowcharts and run instructions; and
- (p) assess the effect of changes to the programs/system on the use of CAAT.

#### **TESTING CAAT**

16. The auditor should obtain reasonable assurance of the integrity, reliability, usefulness, and security of CAAT through appropriate planning, design, testing, processing and review of documentation. This should be done before reliance is placed upon CAAT. The nature, timing and extent of testing is dependent on the commercial availability and stability of CAAT.

#### **CONTROLLING CAAT APPLICATION**

17. The specific procedures necessary to control the use of CAAT depend on the particular application. In establishing control, the auditor considers the need to:

- (a) approve specifications and conduct a review of the work to be performed by CAAT;
- (b) review the entity's general controls that may contribute to the integrity of CAAT, for example, controls over program changes and access to computer files. When such controls cannot be relied on to ensure the integrity of CAAT, the auditor may consider processing CAAT application at another suitable computer facility; and
- (c) ensure appropriate integration of the output by the auditor into the audit process.

18. Procedures carried out by the auditor to control CAATs applications may include:

- (a) participating in the design and testing of CAAT;
- (b) checking, if applicable, the coding of the program to ensure that it conforms with the detailed program specifications;
- (c) asking the entity's staff to review the operating system instructions to ensure that the software will run in the entity's computer installation;
- (d) running the audit software on small test files before running it on the main data files;
- (e) checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete;
- (f) obtaining evidence that the audit software functioned as planned, for example, by reviewing output and control information; and

### III.146 Auditing Pronouncements

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- (g) establishing appropriate security measures to safeguard the integrity and confidentiality of the data.

When the auditor intends to perform audit procedures concurrently with online processing, the auditor reviews those procedures with appropriate client personnel and obtains approval before conducting the tests to help avoid the inadvertent corruption of client records.

19. To ensure appropriate control procedures, the presence of the auditor is not necessarily required at the computer facility during the running of CAAT. It may, however, provide practical advantages, such as being able to control distribution of the output and ensuring the timely correction of errors, for example, if the wrong input file were to be used.

20. Audit procedures to control test data applications may include:

- ◆ controlling the sequence of submissions of test data where it spans several processing cycles;
- ◆ performing test runs containing small amounts of test data before submitting the main audit test data;
- ◆ predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total;
- ◆ confirming that the current version of the programs was used to process the test data; and
- ◆ testing whether the programs used to process the test data were the programs the entity used throughout the applicable audit period.

21. When using CAAT, the auditor may require the cooperation of entity staff with extensive knowledge of the computer installation. In such circumstances, the auditor considers whether the staff improperly influenced the results of CAAT.

22. Audit procedures to control the use of audit-enabling software may include:

- ◆ verifying the completeness, accuracy and availability of the relevant data, for example, historical data may be required to build a financial model;
- ◆ reviewing the reasonableness of assumptions used in the application of the tool set, particularly, when using modeling software;
- ◆ verifying availability of resources skilled in the use and control of the selected tools; and
- ◆ confirming the appropriateness of the tool set to the audit objective, for example, the use of industry specific systems may be necessary for the design of audit programs for unique business cycles.

#### DOCUMENTATION

23. The various stages of application of CAATs should be sufficiently documented to provide adequate audit evidence.

24. The audit working papers should contain sufficient documentation to describe CAAT application, including the details set out in the sections below:

(a) **Planning**

- ◆ CAAT objectives;
- ◆ CAAT to be used;
- ◆ Controls to be exercised; and
- ◆ Staffing, timing and cost.

(b) **Execution**

- ◆ CAAT preparation and testing procedures and controls;
- ◆ Details of the tests performed by CAAT;
- ◆ Details of inputs (e.g., data used, file layouts), processing (e.g., CAATs high-level flowcharts, logic) and outputs (e.g., log files, reports);
- ◆ Listing of relevant parameters or source code; and
- ◆ Relevant technical information about the entity's accounting system, such as file layouts.

(c) **Audit Evidence**

- ◆ Output provided;
- ◆ Description of the audit work performed on the output;
- ◆ Audit findings; and
- ◆ Audit conclusions;

(d) **Other**

- ◆ Recommendations to the entity management; and

In addition, it may be useful to document suggestions for using CAAT in future years.

#### **ARRANGEMENTS WITH THE ENTITY**

25. The auditor may make arrangements for the retention of the data files, such as detailed transaction files, covering the appropriate audit time frame.

26. In order to minimize the effect on the organisation's production environment, access to the organisation's information system facilities, programs/systems and data should be arranged well in advance of the needed time period

27. The auditor should also consider the effect of these changes on the integrity and usefulness of CAAT, as well as the integrity of the programs/system and data used by the auditor.

**USING CAATS IN SMALL ENTITIES**

28. Although the general principles outlined in this Guidance Note apply in small entity IT environments, the following points need special consideration:

- (a) The level of general controls may be such that the auditor will place less reliance on the system of internal control. This will result in greater emphasis on tests of details of transactions and balances and analytical review procedures, which may increase the effectiveness of certain CAATs, particularly, audit software.
- (b) Where smaller volumes of data are processed, manual methods may be more cost effective.
- (c) A small entity may not be able to provide adequate technical assistance to the auditor, making the use of CAATs impracticable.
- (d) Certain audit package programs may not operate on small computers, thus restricting the auditor's choice of CAATs. The entity's data files may, however, be copied and processed on another suitable computer.

**Appendix**

**Examples of Computer Assisted Audit Techniques**

Techniques	Description	Advantages	Disadvantages
Audit Automation	<ul style="list-style-type: none"> <li>◆ Expert Systems</li> <li>◆ Tools to evaluate a client's risk management procedures</li> <li>◆ Electronic working papers, which provide for the direct extraction of data from clients computer records</li> <li>◆ Corporate and financial modeling programs for use as predictive audit test</li> </ul>	<ul style="list-style-type: none"> <li>◆ These techniques are more useful when auditors are using laptops which can be directly linked with the entity's system.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Not applicable in the case of mainframe computers.</li> </ul>

Audit Software	<ul style="list-style-type: none"> <li>◆ Software used by the auditor to read data on client's files, to provide information for the audit and/or to re-perform procedures carried out by the client's programs.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Performs a wide variety of audit tasks</li> <li>◆ Long term economies</li> <li>◆ Reads actual records</li> <li>◆ Capable of dealing with large volumes of transactions</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a reasonable degree of skill to use</li> <li>◆ Initial set up costs can be high</li> <li>◆ Adaptation often needed from machine to machine</li> </ul>
Core Image Comparison	Software used by the auditor to compare the executable version of a program with a secure master copy	<ul style="list-style-type: none"> <li>◆ Provides a high degree of comfort concerning the executable version of the program</li> <li>◆ Particularly useful where only executable versions are distributed</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a high degree of skill to set up and to interpret the results.</li> <li>◆ Where programs have been recompiled the comparison may be invalidated as the program records everything as a difference</li> <li>◆ Printouts are hard to interpret and the actual changes made are difficult to establish</li> <li>◆ Availability restricted to certain machine types</li> </ul>
Database Analysers	Software used by the auditor to examine the rights associated with terminals and the ability of users to access information on a database	<ul style="list-style-type: none"> <li>◆ Provides detailed information concerning the operation of the database</li> <li>◆ Enhances the auditor's understanding of the database management system</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a high degree of skill to set up and to interpret the results</li> <li>◆ Restricted availability both as regards machine types and database management systems</li> <li>◆ Specific and limited audit applicability</li> </ul>
Embedded Code	Software used by the auditor to examine	<ul style="list-style-type: none"> <li>◆ Performs a wide variety of</li> </ul>	<ul style="list-style-type: none"> <li>◆ There is a processing overhead involved</li> </ul>

### III.150 Auditing Pronouncements

	transactions passing through the system by placing his own program in the suite of programs used for processing.	<p>audit tasks</p> <ul style="list-style-type: none"> <li>◆ Examines each transaction as it passes through the system</li> <li>◆ Operates continuously</li> <li>◆ Capable of identifying unusual transactions passing through the system.</li> </ul>	<p>because of the extra programs</p> <ul style="list-style-type: none"> <li>◆ Definition of what constitutes an unusual transaction needs to be very precise</li> <li>◆ Precautions need to be taken over the output from the programs to ensure is security</li> <li>◆ Precautions need to be taken to ensure that the program cannot be suppressed or tampered with</li> <li>◆ Requires some degree of skill to use and to interpret the results</li> </ul>
Log Analysers	Software used by the auditor to read and analyse records of machine activity	<ul style="list-style-type: none"> <li>◆ Provides detailed information on machine usage.</li> <li>◆ Long term economies</li> <li>◆ Effective when testing integrity controls</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a high degree of skill to use and to interpret the results</li> <li>◆ Limited availability as regards machine types</li> <li>◆ High volume of records restricts extent of test</li> </ul>
Mapping	Software used by the auditor to list unused program instructions	<ul style="list-style-type: none"> <li>◆ Identifies program code which may be there for fraudulent reasons.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Very specific objective</li> <li>◆ Requires a high degree of skill to use and to interpret the results</li> <li>◆ Adaptation needed from machine to machine.</li> </ul>
Modelling	A variety of software, usually associated with a microcomputer, enabling the auditor to carry out analytical	<ul style="list-style-type: none"> <li>◆ Can be a very powerful analytical tool</li> <li>◆ Can enable the auditor to examine</li> </ul>	<ul style="list-style-type: none"> <li>◆ A high volume of data may need to be entered initially</li> <li>◆ Results require careful interpretation</li> </ul>

	reviews of client's results, to alter conditions so as to identify amounts for provisions or claims, or to project results and compare actual results with those expected	provisions on a number of different bases <ul style="list-style-type: none"> <li>◆ Very flexible in use</li> <li>◆ Can provide the auditor with useful information on trends and patterns</li> </ul>	
On-line Testing	Techniques whereby the auditor arranges or manipulates data either real or fictitious, in order to see that a specific program or screen edit test is doing its work	<ul style="list-style-type: none"> <li>◆ Very widely applicable</li> <li>◆ Easy to use</li> <li>◆ Can be targeted for specific functions carried out by programs</li> </ul>	<ul style="list-style-type: none"> <li>◆ Each use satisfies only one particular objective</li> <li>◆ Care must be taken to ensure that "live" data does not impact actual results</li> </ul>
Program Code Analysis	An examination by the auditor of the source code of a particular program with a view to following the logic of the program so as to satisfy himself that it will perform according to his understanding	<ul style="list-style-type: none"> <li>◆ Gives a reasonable degree of comfort about the program logic</li> <li>◆ The auditor can examine every function of the program code</li> </ul>	<ul style="list-style-type: none"> <li>◆ The auditor must understand the program language</li> <li>◆ The auditor needs to check that the source code represents the version in the source library, and that this version equates to the executable version</li> </ul>
Program Library Analysers	Software used by the auditor to examine dates of changes made to the executable library and the use of utilities to amend programs	<ul style="list-style-type: none"> <li>◆ Provides the auditor with useful information concerning the program library</li> <li>◆ Identifies abnormal changes to the library</li> </ul>	<ul style="list-style-type: none"> <li>◆ Requires a high degree of skill to use and to interpret the results</li> <li>◆ Availability restricted to certain machine types</li> <li>◆ Only relevant when testing integrity controls</li> </ul>

### III.152 Auditing Pronouncements

		<ul style="list-style-type: none"> <li>◆ Useful when testing program security</li> </ul>	
Snapshots	Software used by the auditor to take a "picture" of a file of data or a transaction passing through the system at a particular point in time	<ul style="list-style-type: none"> <li>◆ Permits the auditor to examine processing at a specific point in time to carry out tests, or to confirm the way a particular aspect of the system operates</li> </ul>	<ul style="list-style-type: none"> <li>◆ Can be expensive to set up</li> </ul>
Source Comparison	Software used by the auditor to compare the source version of a program with a secure master copy	<ul style="list-style-type: none"> <li>◆ Compares source code line by line and identifies all differences</li> <li>◆ Useful when testing integrity controls or particularly important program procedures</li> </ul>	<ul style="list-style-type: none"> <li>◆ Other procedures are necessary to ensure that the executable version reflects the source code examined</li> <li>◆ Requires some degree of skill to use and to interpret the results</li> <li>◆ Availability restricted to certain machine types</li> </ul>
Test Data - "Live", "Dead", Integrated Test Facility or Base Case System Evaluation	Fictitious data applied against the client's programs either whilst they are running or in an entirely separate operation. The results of processing the fictitious data are compared with the expected results based on the auditor's understanding of the programs involved	<ul style="list-style-type: none"> <li>◆ Performs a wide variety of tasks</li> <li>◆ Gives considerable comfort about the operation of programs</li> <li>◆ Can be precisely targeted for specific procedures within programs</li> </ul>	<ul style="list-style-type: none"> <li>◆ "Dead" test data requires additional work for the auditor to satisfy himself the right programs were used</li> <li>◆ Care must be taken to ensure that "live" data does not impact actual results</li> <li>◆ Technique can be expensive to set up and cumbersome to use</li> <li>◆ Adequate for detection of major error but less likely to detect deep-</li> </ul>

		◆ Long term economies	seated fraud
Tracing	Software used by the auditor to identify which instructions were used in a program and in what order	◆ Helps to analyse the way in which a program operates	<ul style="list-style-type: none"><li>◆ There may be less costly ways to achieve the same objectives, although not in the same detail</li><li>◆ Requires a high degree of skill to use and to interpret the results</li><li>◆ Adaptation needed from machine to machine</li></ul>

## **GUIDANCE NOTE ON AUDIT OF PAYMENT OF DIVIDEND\***

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*The following is the text of the Guidance Note on Audit of Payment of Dividend issued by the Auditing and Assurance Standards Board of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Standards on Auditing issued by the Institute.*

1. Paragraph 2.1 of the "Preface to the Statements on Standard Auditing Practices<sup>1</sup>" issued by the Institute of Chartered Accountants of India states that the "main function of the Auditing Practices Committee (APC)<sup>2</sup> is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs)<sup>3</sup> so that these may be issued by the Council of the Institute". Paragraph 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary".
2. The Auditing and Assurance Standards Board has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Board. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Payment of Dividends, paragraphs 8.19 to 8.24 of the "Capital and Reserve" section of "Statement on Auditing Practices" shall stand withdrawn.<sup>4</sup>

### **Introduction**

3. Guidance Note on Terms Used in the Financial Statements, issued by the Institute, defines dividend as "A distribution to shareholders out of profits or reserves available for this purpose".
4. Dividend means a return on shares held in an entity and payable out of distributable surplus. The dividends, which are paid on winding up, are in fact distribution of the entity's assets and not of profits, even if those assets include some profit earned on winding up of the entity. However, the proviso to section 205(3) of the aforementioned Act permits a company to capitalise its profits by issuing fully paid bonus shares or paying up any amount being unpaid on shares held by its members. Further, under section 205(3) of the Companies Act, 1956, no dividend is payable otherwise than in cash.

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\* Issued in August, 2005.

<sup>1</sup> The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.I of this Handbook.

<sup>2</sup> Now known as the Auditing and assurance Standards Board (AASB).

<sup>3</sup> Now known as Engagement Standards.

<sup>4</sup> Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

5. Dividend includes any interim dividend. It may also be noted that in case of a company, provisions of section 205, 205A, 205C, 206, 206A and 207 of the Companies Act, 1956 apply to interim dividend as well.

6. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions as laid down in paragraph 6 of the Standard on Auditing 500, "Audit Evidence". In carrying out the audit of payment of dividends, the auditor's primary objective is to obtain sufficient appropriate audit evidence to satisfy himself that dividend has been declared and paid in accordance with the applicable provisions, if any, of the relevant laws and regulations applicable to the entity and that all the transactions relating to declaration and payment of dividend have been properly accounted for and disclosed. The auditor's scope of examination would, therefore, include:

- (a) verifying whether dividend has been declared out of distributable surplus after proper authorisation, as required under law;
- (b) evaluating the internal control system regarding procedure of preparation and issuance of dividend warrants /instructions for direct transfer of funds to the shareholders' accounts and also check the timeliness of dispatch of warrants and deposition of the dividend amount in the separate bank account, if any, maintained for this purpose;
- (c) examining compliance with the requirements of the relevant laws and regulations relating to payment of dividend, for example, mandatory transfer to a reserve fund or transfer to other funds, such as unclaimed dividend account., Investor Education and Protection Fund, etc., as applicable to the entity; and
- (d) examining the system for recording and appropriate disclosure of transactions during the year relating to payment of dividend.

#### **Internal Control Evaluation**

7. The auditor should ascertain whether the governing charter, for example, Articles of Association in case of a company, or any similar document of the entity, permits payment of dividend to the members by the entity. For example, a company formed under section 25 of the Companies Act, 1956 is prohibited under the said section itself from paying any dividend to its members.

8. The auditor should study and evaluate the system of internal control relating to payment of dividend to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects relating to payment of dividend:

- (a) whether all transactions in the dividend account have been authorised by the competent authority;
- (b) whether the registers containing the details of members and dividend have been properly maintained by the entity;
- (c) whether there is an effective system of segregation of duties in place. Special attention should be given to the segregation of the duties towards maintenance of shareholders' register, preparation of dividend warrants and maintenance of warrant dispatch register;

### III.156 Auditing Pronouncements

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- (d) the internal control procedures with regard to preparation of dividend warrants and posting them to the members, or the instructions given for electronic transfer of funds or any other mode of payment of dividend to the members, and records maintained to record the details of unclaimed dividend. Separate records of unclaimed dividend should be maintained for each year's dividend/interim dividend;
- (e) the procedures for payment of unclaimed dividend and should satisfy himself that they are not paid without adequate safeguards being taken as to identification of the payee, checking of the payee's claim, etc.

In case, the above activities are outsourced, the auditor should evaluate the activities of the service organisation and if finds them significant, he should obtain sufficient information to understand the accounting and internal control systems of the service organisation and assess control risk at either the maximum or a lower level, as appropriate, if tests of control are performed. For detailed guidance in this respect, reference may be made to Standard on Auditing 402, "Audit Considerations Relating to Entities Using Service Organisations."

#### Verification

9. Verification of payment of dividend may be carried out by performing the following procedures:

- (a) examination of compliance with laws and regulations and such other relevant information having a bearing on payment of dividend; and
- (b) examination of the system of maintenance of records.

10. The auditor should verify the compliance with laws and regulations, provisions contained in the governing charter, e.g. Articles of Association in case of companies, bye-laws or rules and directions/instructions issued by any regulatory authority applicable to the entity and/or the terms of the banks/financial institutions which may lay down certain restrictions or conditions on declaration of dividend. For example:

- (a) In case of companies, the following conditions have to be complied with before declaration of dividend:
  - ◆ It has provided for depreciation for any previous financial year(s) which fall(s) after the commencement of the Companies (Amendment) Act, 1960 [section 205(1)] and further that such depreciation has been computed in accordance with the requirements of section 350 and other provisions of section 205(2) of the Act
  - ◆ It has provided for any losses incurred in any previous financial year(s) which fall(s) after the commencement of the Companies (Amendment) Act, 1960 [section 205(1)]
  - ◆ Where the company has declared dividend for any financial year out of the profits for that year, it has also transferred to a reserve such percentage (or a higher percentage) of profits as may be prescribed in the Companies (Transfer of Profits to Reserves) Rules, 1975 [section 205(2A)]
  - ◆ It has complied with the requirements of section 80A, dealing with redemption of irredeemable preference shares etc., of the Companies Act, 1956.

- (b) Under the Banking Regulation Act, 1949, dividend can not be paid without first writing off intangible assets and transferring certain percentage of profits to statutory reserves unless permitted by the Central Government to do so. Section 17 of the Banking Regulation Act, 1949 requires that a banking company incorporated in India must transfer twenty per cent of its annual profits to a reserve fund before any dividend is distributed unless a specific exemption has been obtained from the Central Government.
- (c) State Co-operative laws lay down that certain percentage of profits have to be transferred to various reserves and a minimum percentage of profit has to be paid as dividend.

11. The auditor has to verify that the dividend is declared only out of distributable surplus. For example, in case of a company, under section 205 of the Companies Act, 1956, dividends can be distributed out of profits for the year in which dividend is declared, accumulated profits of any preceding year or under any guarantee given by Central or any State Government.

12. The auditor should verify that a specific resolution for payment of dividend has been duly passed at the meeting of the Board or any similar authority. In case of interim dividend, the dividend declared by the Board of Directors or similar authority is final. In case of final dividend, the auditor should also verify that the recommendations of the Board have been approved by the members at the annual general meeting. It may, however, be noted that in case of companies, the members can reduce the amount of dividend or decide for non-payment of dividend but they can not increase the dividend recommended by the Board.

13. If the entity has non-voting shares and/or shares with variable rights and /or preference shares with various options like, cumulative, participatory, etc., the resolution declaring the dividend should also specify different rates of dividend on the shares having variable rights or preferential rights as to dividend. In such cases, the auditor has to verify that the dividend paid is in accordance with the terms of the resolution and also the resolution is in accordance with the terms attached to these shares.

14. Other laws and regulations, relating to payment of dividend, governing the entity may impose similar or other restrictions. The auditor has to be familiar with the laws and regulations governing the entity and verify whether these laws and regulations have been complied with. For example, the auditor has to examine the compliance with provisions of the Foreign Exchange Management Act, 1999 for the payment of dividend in foreign currency pursuant to issue of shares to non-residents and issue of ADR/GDR. **Appendix** to this Guidance Note contains relevant extracts of the provisions of various statutes having a bearing on the declaration and payment of dividend.

15. In case of a listed company, the auditor should also verify whether the provisions of the Listing Agreement as to declaration of dividend, e.g., prior intimation to the Stock Exchange about the Board meeting at which declaration/recommendation of dividend is to be considered, intimation to Stock Exchanges of all dividends and/or cash bonuses recommended or declared or the decision to pass any dividend or interest payment at the Board meeting, have been complied with or not.

### III.158 Auditing Pronouncements

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

17. The auditor should examine that the mandatory transfer of the amount specified to a separate fund, where so required by the relevant laws and regulations, have been made before payment of dividend.

18. The auditor has to verify that the dividend is paid in accordance with the terms prescribed in resolution by the Board/members.

19. The auditor should verify that the dividend warrants have been dispatched to the members within the time limit prescribed.

20. If an interim dividend is declared, the auditor has to verify whether the same is approved in a general meeting of the members and the provisions contained in the Articles of Association or bye-laws or other statutes governing the body corporate permit it to pay interim dividend. In case of statutory corporations and nationalised banks, the Board may be empowered to declare and pay the dividend and resolution by the members may not be necessary. In case of companies, the auditor should verify that the financial statements have been prepared and presented before the Board and the Board while considering the interim dividend, has taken into account the depreciation to be provided for the full year, profit to be transferred to reserves under Companies (Transfer of Profits to Reserves) Rules, 1975 and the dividend payable to preference shareholders.

21. If the laws and regulations applicable to the entity require it to deposit the amount of dividend, interim and/or final, in a separate bank account, the auditor has to verify whether such transfer of funds to the separate account has been made within the prescribed time limit. The auditor should also verify the compliance of law with regard to unclaimed dividend. For example, in case of companies, the dividend declared has to be deposited within prescribed period in a separate bank account and if dividend is not claimed within such number of days, of such transfer, as may be specified by the Companies Act, 1956 or rules made thereunder and the amount remaining in the separate bank account has to be transferred to unpaid dividend account separately opened with any scheduled bank and the amount remaining in that account after the expiry of such period of opening such unpaid dividend account, as may be prescribed together with interest accrued thereon, if any, has to be transferred to Investor Education and Protection Fund Account established under the Companies Act, 1956. It may be noted, that within specified number of months prior to the transfer of unclaimed dividend to Investor Education & Protection Fund, the company has to give notice to individuals who have not claimed such dividend. If the auditor finds that the amounts required to be transferred as above have a material effect on the financial statements, and have not been properly reflected in the financial statements, the auditor should assess the impact of such non-compliance on his audit report.

22. The auditor should verify that adjustment, if any, made in the dividend payable, towards calls in arrears or any other sums due from members is in accordance with the terms of issue, laws and regulations applicable to the entity.

23. The auditor may verify the total amount of dividend transferred to a separate bank account is in agreement with the statement prepared by the body corporate reconciling the total dividend payable on shares in physical form, dematerialised form, and dividend withheld in respect of shares pending for registration of transfer and adjustments, if any, made for the calls in arrears and other dues from the members.

24. The listed companies are required to electronically transfer dividend to bank accounts of the shareholders, wherever Electronic Clearing Services (ECS) facility is available and the members/depositories furnish details of the respective bank accounts of the members and in respect of others, distribute the dividend through dividend warrants. In such cases, in addition to test checks for individual payments, the auditor should examine the overall reconciliation of the total payment made through electronic transfer and payment made through dividend warrants.

25. The auditor should verify that the dividend is paid:

(a) (i) in respect of shares held in electronic form, to those persons whose details as on record date/book closure date are furnished by the depositories; and/or

(ii) in respect of shares held in physical form, to the members whose names are appearing on the record date/ immediately after effecting the transfers submitted till the date of book closure; and

(b) in respect of share warrants to the holders of share warrants.

26. The auditor should apply the analytical procedures before forming any overall conclusion so as to find out any material fluctuations and deviations from the relevant information that he has gained during the course of audit. Such analytical procedures may be regarding the changes in the shareholding pattern, dividend pay out ratio, ratio of gross dividend payable to the paid up share capital or ratio of net dividend payable with the gross dividend payable by the entity. In case of listed companies, the auditor may also review the minutes of the meetings of the Investors' Grievances Committee, wherever such Committee exists, to have an overview of the nature and number of complaints related to dividends as the same would provide the auditor an additional evidence as to the efficacy of the internal control system in relation to payment of dividend.

27. The auditor should verify that the total amount remaining in the unclaimed dividend account, for example, because of dispute about ownership on account of court cases etc., or the amount not claimed by shareholders, tallies with the schedule of unclaimed dividend for each year for which dividend remains unclaimed.

28. The auditor has to verify that in case the entity proposes to pay dividend out of its accumulated reserves, whether the same has been paid after complying with the statutory requirements, if any. For example, a company can pay dividend out of its accumulated reserves only after complying with the provisions of sub-section (3) of Section 205A of the Companies Act, 1956 and the Companies (Declaration of Dividend out of Profits) Rules, 1975. These Rules provide for the maximum amount that can be paid as dividend. In cases where the company declares dividend that is not in accordance with these Rules, the auditor must

### **III.160 Auditing Pronouncements**

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verify that the company has obtained prior approval from the Central Government for the same. Similar provisions, if any, in the laws applicable to other entities have to be complied with.

29. The auditor should also verify that:

- (a) If capital profits are distributed as dividend:
  - (i) the Articles or the bye-laws or other rules and regulations applicable to the entity, permit such distribution; and
  - (ii) it has been realised in cash; and
  - (iii) the Board or similar authority is satisfied that net aggregate value of the assets remaining after distribution of that profit will not be less than the book values so that share capital and reserves remaining after the distribution will be fully represented by the remaining assets.
- (b) Capital surplus arising on the revaluation of fixed assets is not directly or indirectly available for distribution as dividend.
- (c) Any reserve in the nature of capital reserve arising on acquisition of a business as a going concern or on amalgamation in the nature of purchase and Securities premium collected on the issue of securities can not be utilised for declaration of dividend.

#### **Disclosure**

30. Proposed dividend should be shown as appropriation of profit in the Profit and Loss Account and as provision under "Provisions" in the Balance Sheet.

31. Unclaimed dividends should be shown in Balance Sheet under the head "Current Liabilities".

32. In respect of companies, all arrears of cumulative preference dividends should be shown as a contingent liability.

#### **Management Representation**

33. The auditor should obtain representation from the management of the entity about the amount retained in unclaimed dividend account by reason of disputes pending in various courts of law and also that it has complied with all laws and regulations applicable to the provisioning and payment of dividend including transfers to Unclaimed Dividend Fund or any other fund such as Investors Education and Protection Fund, where so required and that the dividend has been paid to the persons entitled to it.

#### **Documentation**

34. The auditor's working papers should contain the plan devised for verification of payment of dividend. Among other papers, he should maintain in his audit file, the management representations and any other relevant document, such as copy of the Board resolution authorising payment of dividend, etc. He should ensure that all significant matters that require the exercise of his professional judgment, together with the auditor's conclusion thereon have been properly included in his working papers.

*Appendix*

**Provisions of Certain Acts and Rules  
With Regard to Declaration and Payment of Dividend<sup>5</sup>**

**The Companies Act, 1956**

**205. Dividend to be Paid only out of Profits** – (1) No dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with those provisions and remaining undistributed or out of both or out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government:

Provided that –

- (a) if the company has not provided for depreciation for any previous financial year or years which falls or fall after the commencement of the Companies (Amendment) Act, 1960 (65 of 1960) it shall, before declaring or paying dividend for any financial year provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial year or years;
- (b) if the company has incurred any loss in any previous financial year or years, which falls or fall after the commencement of the Companies (Amendment ) Act, 1960 (65 of 1960) then, the amount of the loss or an amount which is equal to the amount provided for depreciation for that year or those years whichever is less, shall be set off against the profits of the company for the year for which dividend is proposed to be declared or paid or against the profits of the company for any previous financial year or years, arrived at in both cases after providing for depreciation in accordance with the provisions of sub-section (2) or against both;
- (c) the Central Government may, if it thinks necessary so to do in the public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing for depreciation:

Provided further that it shall not be necessary for a company to provide for depreciation as aforesaid where dividend for any financial year is declared or paid out of the profits of any previous financial year or years which falls or fall before the commencement of the Companies (Amendment) Act, 1960 (65 of 1960).

- (1A) The Board of directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited in a separate bank account within five days from the date of declaration of such dividend.

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<sup>5</sup> The Acts and Rules specified in this Appendix are only illustrative in nature and are not meant to be exhaustive for the purposes of the laws dealing with the payment of dividend by different entities.

### III.162 Auditing Pronouncements

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- (1B) The amount of dividend including interim dividend so deposited under sub-section (1A) shall be used for payment of interim dividend.
- (1C) The provisions contained in sections 205, 205A, 205C, 206, 206A and 207 shall, as far as may be, also apply to any interim dividend.
- (2) For the purpose of sub-section (1), depreciation shall be provided either –
- (a) to the extent specified in section 350; or
  - (b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five per cent of the original cost thereof to the company by the specified period in respect of such asset; or
  - (c) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation ninety-five per cent of the original cost to the company of each such depreciable asset on the expiry of the specified period; or
  - (d) as regards any other depreciable asset for which no rate of depreciation has been laid down by this Act or any rules made there under, on such basis as may be approved by the Central Government by any general order published in the Official Gazette or by any special order in any particular case:

Provided that where depreciation is provided for in the manner laid down in clause (b) or clause (c), then, in the event of the depreciable asset being sold, discarded, demolished or destroyed the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the proviso to section 350.

(2A) Notwithstanding anything contained in sub-section (1), on and from the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), no dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2), except after the transfer to the reserves of the company of such percentage of its profits for that year, not exceeding ten per cent, as may be prescribed:

Provided that nothing in this sub-section shall be deemed to prohibit the voluntary transfer by a company of a higher percentage of its profits to the reserves in accordance with such rules as may be made by the Central Government in this behalf.

(2B) A company which fails to comply with the provisions of section 80A shall not, so long as such failure continues, declare any dividend on its equity shares.

(3) No dividend shall be payable except in cash:

Provided that nothing in this sub-section shall be deemed to prohibit the capitalization of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount, for the time being unpaid, on any shares held by the members of the company.

(4) Nothing in this section shall be deemed to affect in any manner the operation of the section 208.

- (5) For the purposes of this section –
- (a) “specified period” in respect of any depreciable asset shall mean the number of years at the end of which at least ninety-five per cent of the original cost of that asset to the company will have been provided for by way of depreciation if depreciation were to be calculated in accordance with the Provisions of section 350;
- (b) any dividend payable in cash may be paid by cheque or warrant sent through the post directed to the registered address of the shareholder entitled to the payment of the dividend, or in the case of joint shareholders, to the registered address of that one of the joint shareholders which is first named on the register of members, or to such person and to such address as the shareholder or the joint shareholders may in writing direct.

**205A. Unpaid dividend to be transferred to special dividend account—**

(1) Where, after the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), a dividend has been declared by a company but has not been paid, or claimed, within thirty days from the date of the declaration, to any shareholder entitled to the payment of the dividend, the company shall, within seven days from the date of expiry of the said period of thirty days, transfer the total amount of dividend which remains unpaid or unclaimed within the said period of thirty days to a special account to be opened by the company in that behalf in any scheduled bank, to be called “Unpaid Dividend Account of ..... Company Limited/ Company (Private) Limited”.

*Explanation:* In this sub-section, the expression “dividend which remains unpaid” means any dividend the warrant in respect thereof has not been encashed or which has otherwise not been paid or claimed.

(2) Where the whole or any part of any dividend, declared by a company before the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), remains unpaid at such commencement, the company shall within a period of six months from such commencement, transfer such unpaid amount to the account referred to in sub-section (1).

(3) Where, owing to inadequacy or absence of profits in any year, any company proposes to declare dividend out of the accumulated profits earned by the company in previous years and transferred by it to the reserves, such declaration of dividend shall not be made except in accordance with such rules as may be made by the Central Government in this behalf, and, where any such declaration is not in accordance with such rules, such declaration shall not be made except with the previous approval of the Central Government.

(4) If the default is made in transferring the total amount referred to in sub-section (1) or any part thereof to the unpaid dividend account of the concerned company, the company shall pay, from the date of such default, interest on so much of the amount as has not been transferred to the said account, at the rate of twelve per cent per annum and the interest accruing on such amount shall ensure to the benefit of the members of the company, in proportion to the amount remaining unpaid to them.

(5) Any money transferred to the unpaid dividend account of a company in pursuance of this section which remains unpaid or unclaimed for a period of seven years from the date of such

### III.164 Auditing Pronouncements

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transfer shall be transferred by the company to the fund established under sub-section (1) of section 205 C.

(6) The company shall, when making any transfer under sub-section (5) to the Fund established under section 205C any unpaid or unclaimed dividend, furnish to such authority or committee as the Central Government may appoint in this behalf a statement in the prescribed form setting forth in respect of all sums included in such transfer, the nature of the sums, the names and last known addresses of the persons entitled to receive the sum, the amount to which each person is entitled and the nature of his claim thereto, and such other particulars as may be prescribed.

(7) The company shall be entitled to a receipt from the authority or committee under sub-section (4) of section 205C for any money transferred by it to the Fund and such a receipt shall be an effectual discharge of the company in respect thereof.

(8) If a company fails to comply with any of the requirements of this section, the company and every officer of the company who is in default, shall be punishable with fine which may extend to five thousand rupees for every day during which the failure continues.

**205 B. Payment of unpaid or unclaimed dividend—** Any person claiming to be entitled to any money transferred under sub-section (5) of section 205A to the general revenue account of the Central Government, may apply to the Central Government for an order for payment of the money claimed; and the Central Government may, if satisfied, whether on a certificate by the company or otherwise, that such person is entitled to the whole or any part of the money claimed, make an order for the payment to that person of the sum due to him after taking such security from him as it may think fit:

Provided that nothing contained in this section shall apply to any person claiming to be entitled to any money transferred to the fund referred to in section 205C on and after the commencement of the Companies (Amendment) Act, 1999.

**205C. Establishment of Investor Education and Protection Fund—** (1) The Central Government shall establish a fund to be called the Investor Education and Protection Fund (hereafter in this section referred to as the "Fund").

(2) There shall be credited to the Fund the following amounts, namely:

- (a) amounts in the unpaid dividend accounts of companies;
- (b) the application moneys received by companies for allotment of any securities and due for refund;
- (c) matured deposits with companies;
- (d) matured debentures with companies;
- (e) the interest accrued on the amounts referred to in clauses (a) to (d);
- (f) grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purposes of the Fund; and
- (g) the interest or other income received out of the investments made from the Fund:

Provided that no such amounts referred to in clauses (a) to (d) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

*Explanation:* For the removal of doubts, it is hereby declared that no claims shall lie against the Fund or the company in respect of individual amounts which were unclaimed and unpaid for a period of seven years from the dates that they first became due for payment and no payment shall be made in respect of any such claims.

(3) The Fund shall be utilised for promotion of investor's awareness and protection of the interests of investors in accordance with such rules as may be prescribed.

(4) The Central Government shall, by notification in the Official Gazette, specify an authority or committee, with such members as the Central Government may appoint, to administer the Fund, and maintain separate accounts and other relevant records in relation to the Fund in such form as may be prescribed in consultation with the Comptroller and Auditor – General of India.

(5) It shall be competent for the authority or committee appointed under sub-section (4) to spend moneys out of the Fund for carrying out the objects for which the Fund has been established.

**206. Dividend not to be paid except to registered shareholders or to their order or to their bankers—**(1) No dividend shall be paid by a company in respect of any share therein, except—

- (a) to the registered holder of such share or to his order or to his bankers; or
- (b) in case a share warrant has been issued in respect of the share in pursuance of section 114, to the bearer of such warrant or to his bankers.

(2) Nothing contained in sub-section (1) shall be deemed to require the bankers of a registered shareholder to make a separate application to the company for the payment of the dividend.

**206A. Right to dividend, right shares and bonus shares to be held in abeyance pending registration of transfer of shares—** Where any instrument of transfer of shares has been delivered to any company for registration and the transfer of such shares has not been registered by the company, it shall, notwithstanding anything contained in any other provisions of this Act,—

- (a) transfer the dividend in relation to such shares to the special account referred to in section 205A unless the company is authorised by the registered holder of such share in writing to pay such dividend to the transferee specified in such instrument of transfer; and
- (b) keep in abeyance in relation to such shares any offer of rights shares under clause (a) of sub-section (1) of section 81 and any issue of fully paid-up bonus shares in pursuance of sub-section (3) of section 205.

**207. Penalty for failure to distribute dividends within thirty days** – Where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof has not been posted, within thirty days from the date of declaration, to any shareholder entitled to the payment of the dividend, every director of the company shall, if he is knowingly a party to the default, be punishable with simple imprisonment for a term which may extend to three years and shall also be liable to a fine of one thousand rupees for every day during which such default continues and the company shall be liable to pay simple interest at the rate of eighteen per cent per annum during the period for which such default continues:

Provided that no offence shall be deemed to have been committed within the meaning of the foregoing provisions in the following cases, namely:

- (a) where the dividend could not be paid by reason of the operation of any law;
- (b) where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with;
- (c) where there is a dispute regarding the right to receive the dividend;
- (d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or
- (e) where, for any other reason, the failure to pay the dividend or to post the warrant within the period aforesaid was not due to any default on the part of the company.

**Companies (Transfer of Profits to Reserves) Rules, 1975**

**[GSR 426 (E), Dated 24-7-1975]**

*In exercise of the powers conferred by sub-section (2A) of section 205, read with clause (a) of subsection (1) of section 642, of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following rules, namely:*

**Short title**

1. These rules may be called the Companies (Transfer of Profits to Reserves) Rules, 1975.

**Percentage of profits to be transferred to reserves**

2. No dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) of section 205 of the Act, except after the transfer to the reserves of the company of a percentage of its profits for that year as specified below:

- (i) where the dividend proposed exceeds 10 per cent but not 12.5 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 2.5 per cent of the current profits;
- (ii) where the dividend proposed exceeds 12.5 per cent but does not exceed 15 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 5 per cent of the current profits;

- (iii) where the dividend proposed exceeds 15 per cent but does not exceed 20 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 7.5 per cent of the current profits; and
- (iv) where the dividend proposed exceeds 20 per cent of the paid-up capital, the amount to be transferred to reserves shall not be less than 10 per cent of the current profits.

#### **Conditions governing voluntary transfer of a higher percentage**

3. Nothing in rule 2 shall be deemed to prohibit the voluntary transfer by a company of a percentage higher than 10 per cent of its profits to its reserves for any financial year, so however, that:

- (i) Where a dividend is declared, -
  - (a) a minimum distribution sufficient for the maintenance of dividends to shareholders at a rate equal to the average of the rates at which dividends declared by it over the three years immediately preceding the financial year, or
  - (b) in a case where bonus shares have been issued in the financial year in which the dividend is declared or in the three years immediately preceding the financial year, a minimum distribution sufficient for the maintenance of dividends to share holders at an amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial year, is ensured:

**Provided** that in a case where the net profits after tax are lower by 20 per cent or more than the average net profits after tax of the two financial years immediately preceding, it shall not be necessary to ensure such minimum distribution,

- (ii) where no dividend is declared, the amount proposed to be transferred to its reserves from the current profits shall be lower than the average amount of the dividends to the shareholders declared by it over the three years immediately preceding the financial year.

#### **Penalty**

4. If a company fails to comply with any of the provisions contained in these rules, the company and every officer of the company in default, shall be punishable with fine which may extend to five hundred rupees, and, where the contravention is a continuing one, with a further fine which may extend to fifty rupees for every day, after the first, during which such contravention continues.

#### **Companies (Declaration of Dividend out of Reserves) Rules, 1975**

[GSR No. 427 (E), Dated 24-7- 1975]

*In exercise of the powers conferred by sub-section (3) of section 205A, read with clause (a) of sub-section (1) of section 642, of the Companies Act, 1956 (1 to 1956), the Central Government hereby makes the following rules, namely:*

**Short title**

1. These rules may be called the Companies (Declaration of Dividend out of Reserves) Rules, 1975.

**Declaration of dividend out of reserves**

2. In the event of inadequacy or absence of profits in any year, dividend may be declared by a company for that year out of the accumulated profits earned by it in previous years and transferred by it to the reserves, subject to the conditions that -

- (i) the rate of the dividend declared shall not exceed the average of the rates at which dividend was declared by it in the five years immediately preceding that year or ten per cent of its paid up capital, whichever is less;
- (ii) the total amount to be drawn from the accumulated profits earned in previous years and transferred to the reserves shall not exceed an amount equal to one-tenth of the sum of its paid-up capital and free reserves and the amount so drawn shall first be utilised to set off the losses incurred in the financial year before any dividend in respect of preference or equity shares is declared; and
- (iii) the balance of reserves after such drawal shall not fall below fifteen per cent of its paid-up share capital.

*Explanation:* For the purposes of this rule, "profits earned by a company in previous years and transferred by it to the reserves" shall mean the total amount of net profits after tax, transferred to reserves as at the beginning of the year for which the dividend is to be declared; and in computing the said amount, the appropriations out of the amount transferred from the Development Rebate Reserve [at the expiry of the period specified under the Income-tax Act, 1961 (43 of 1961)] shall be included and all items of Capital Reserves including reserves created by revaluation of assets shall be excluded.

**Insurance Act, 1938**

**Restriction on dividends and bonuses**

49. (1) No insurer, being an insurer specified in sub-clause (a) (ii) or sub-clause (b) of clause (9) of section 2, who carries on the business of life insurance or any other class or sub-class of insurance business to which section 13 applies, shall, for the purpose of declaring or paying any dividend to shareholders or any bonus to policy-holders or of making any payment in service of any debentures, utilize directly or indirectly any portion of the life insurance fund or of the fund of such other class or sub class of insurance business, as the case may be, except a surplus shown in the valuation balance-sheet in such form as may be specified by the regulations made by the Authority submitted to the Authority as part of the abstract referred to in section 15, as a result of an actuarial valuation of the assets and liabilities of the insurer; nor shall he increase such surplus by contributions out of any reserve fund or otherwise unless such contributions have been brought in as revenue through the revenue account applicable to that class or sub-class of insurance business on or before the date of valuation aforesaid, except when the reserve fund is made up solely of transfers from similar surpluses

disclosed by valuations in respect of which returns have been submitted to the Authority under section 15 of this Act or to the Central Government under section 11 of the Indian Life Assurance Companies Act, 1912 (6 of 1912):

**Provided** that payments made out of any such surplus in service of any debentures shall not exceed fifty per-cent of such surplus including any payment by way of interest on the debentures, and interest paid on the debentures shall not exceed ten per-cent of any such surplus except when the interest paid on the debentures is offset against the interest credited to the fund or funds concerned in deciding the interest basis adopted in the valuation disclosing the aforesaid surplus:

**Provided further** that the share of any such surplus allocated to or reserved for the shareholders (including any amount for the payment of dividends guaranteed to them, whether by way of first charge or otherwise), shall not exceed such sums as may be specified by the Authority and such share shall in no case exceed ten per-cent of such surplus in case of participating policies and in other cases the whole thereof.

(2) For the purposes of sub-section (1), the actual amount of income-tax deducted at source during the period following the date as at which the last preceding valuation was made and preceding the date as at which the valuation in question is made may be added to such surplus after deducting an estimated amount for income-tax on such surplus, such addition and deduction being shown in an abstract of the report of the actuary referred to in sub-section (1) of section 13:

#### **Declaration of interim bonuses**

112. Notwithstanding anything to the contrary contained in this Act, an insurer carrying on the business of life insurance shall be at liberty to declare an interim bonus or bonuses to policy-holders whose policies mature for payment by reason of death or otherwise during the inter-valuation period on the recommendation of the investigating of actuary made at the last preceding valuation.

### **The Banking Regulation Act, 1949**

#### **15. Restrictions as to Payment of Dividend**

(1) No banking company shall pay any dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written off.

(2) Notwithstanding anything to the contrary contained in sub-section (1) or in the Companies Act, 1956 (1 of 1956), a banking company may pay dividends on its shares without writing off-

- (i) the depreciation, if any, in the value of its investments in approved securities in any case where such depreciation has not actually been capitalised or otherwise accounted for as a loss;

### III.170 Auditing Pronouncements

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- (ii) the depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;
- (iii) the bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.

#### 17. Reserve Fund

(1) Every banking company incorporated in India shall create a reserve fund and shall, out of the balance of profit of each year, as disclosed to the profit and loss account prepared under Section 29 and before any dividend is declared, transfer to the reserve fund a sum equivalent to not less than twenty per cent of such profit.

(1A) Notwithstanding anything contained in sub-section (1), the Central Government may, on the recommendation of the Reserve Bank and having regard to the adequacy of the paid-up capital and reserves of a banking company in relation to its deposit liabilities, declare by order in writing that the provisions of sub-section (1) shall not apply to the banking company for such period as may be specified in the order:

**Provided** that no such order shall be made unless, at the time it is made, the amount in the reserve fund under sub-section (1), together with the amount in the share premium account is not less than the paid-up capital of the banking company.

(2) Where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the Reserve Bank, explaining the circumstances relating to such appropriation:

**Provided** that the Reserve Bank may, in any particular case, extend the said period of twenty-one days by such period as it thinks fit or condone any delay in the making of such report.

#### The Regional Rural Banks Act, 1976

21. **Disposal of profits**— After making provisions for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds and all other matters for which provision is, under law, necessary or which are usually provided for by banking companies, a Regional Rural Bank may, out of its net profits, declare a dividend.

#### The Multi-State Co-Operative Societies Act, 2002

62. **Funds not to be divided by way of profit**— (1) No part of the funds, other than net profits, of a multi-State co-operative society shall be divided by way of bonus or dividend or otherwise distributed among its members.

(2) The net profit of a multi-State co-operative society referred to in sub-section (1) in respect of a society earning profits shall be calculated by deducting from the gross profits for the year, all interest accrued and accruing in relation to amounts which are overdue, establishment charges, interest payable on loans and deposits, audit fees, working expenses including repairs, rent, taxes and depreciation, bonus payable to employees under the law

relating to payment of bonus for the time being in force, and equalization fund for such bonus, provision for payment of income-tax and making approved donations under the Income-tax Act, 1961 (43 of 1961), development rebate, provision for development fund, bad debt fund, price fluctuation fund, dividend equalization fund, share capital redemption fund, investment fluctuation fund, provision for retirement benefits to employees, and after providing for or writing off bad debts and losses not adjusted against any fund created out of profit:

Provided that such society may add to the net profits for the year interest accrued in the preceding years, but actually recovered during the year:

Provided further that in the case of such multi-State co-operative societies, as do not have share capital, the surplus of income over expenditure shall not be treated as net profits and such surplus shall be dealt with in accordance with the bye-laws.

**63. Disposal of net profits** (1) A multi-State co-operative society shall, out of its net profits in any year.

- (a) transfer an amount not less than twenty-five per cent to the reserve fund;
  - (b) credit one per cent, to co-operative education fund maintained, by the National Co-operative Union of India Limited, New Delhi, in the manner as may be prescribed;
  - (c) transfer an amount not less than ten per cent, to a reserve fund for meeting unforeseen losses.
- (2) Subject to such conditions as may be prescribed, the balance of the net profits may be utilised for all or any of the following purposes, namely: -
- (a) payment of dividend to the members on their paid-up share capital at a rate not exceeding the prescribed limit;
  - (b) constitution of, or contribution to, such special funds including education funds, as may be specified in the bye-laws;
  - (c) donation of amounts not exceeding five per cent of the net profits for any purpose connected with the development of co-operative movement or charitable purpose as defined in Section 2 of the Charitable Endowments Act, 1890 (6 of 1890);
  - (d) payment of ex-gratia amount to employees of the multi-State co-operative society to the extent and in the manner specified in the bye-laws.

**64. Investment of funds:** A multi-State co-operative society may invest or deposit its funds—

- (a) in a co-operative bank, State co-operative bank, co-operative land development bank or Central co-operative bank; or
- (b) in any of the securities specified in Section 20 of the Indian Trusts Act, 1882 ; or
- (c) in the shares or securities of any other multi-State co-operative society or any co-operative society; or

### III.172 Auditing Pronouncements

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- (d) in the shares, securities or assets of a subsidiary institution or any other institution; or
- (e) with any other bank; or
- (f) in such other mode as may be provided in the bye-laws.

*Explanation:* For the purposes of clause (e), "bank" means any banking company as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949, and includes-

- (a) the State Bank of India constituted under the State Bank of India Act, 1955;
- (b) a subsidiary bank as defined in clause (k) of Section 2 of the State Bank of India (Subsidiary Banks) Act, 1959;
- (c) a corresponding new bank constituted under Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) or a corresponding new bank constituted under Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980).

#### Multi-State Co-operative Societies Rules, 2002

#### 24. Distribution of profit to members.

- (1) No part of the funds, other than net profits of a multi-State co-operative society shall be distributed by way of bonus or dividend or otherwise among its members.
- (2) Payment of dividend to the members on their paid-up share capital shall be as specified in the bye-laws.
- (3) The bye-laws of a multi-State co-operative society may provide for distribution of patronage bonus to its members in consonance with the transactions of a member with the society.
- (4) Every multi-State Co-operative society may also provide for in their bye-laws the subjects and purposes for which the reserve fund will be utilised.

## GUIDANCE NOTE ON AUDIT OF CAPITAL AND RESERVES<sup>1</sup>

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*The following is the text of the Guidance Note on Audit of Capital and Reserves, issued by the Council of the Institute of Chartered Accountants of India. The Guidance Note should be read in conjunction with the Standards on Auditing issued by the Institute.*

### INTRODUCTION

1. Capital and reserves constitute the owners' funds. Capital comprises both the amounts contributed by the owners and the profits capitalised over a period of time (by way of issue of bonus shares in case of corporate entities or by way of crediting the retained earnings to the capital account in case of non-corporate entities).
2. Capital may consist of various classes of shares with varying voting rights in case of corporate entities.
3. Reserves are the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability. Reserves comprise both capital and revenue reserves. Ordinarily, revenue reserves are retained earnings, whereas the capital reserves may constitute both retained capital profits and owners' contribution in the form of premium on issue of shares and surpluses resulting from re-issue of forfeited shares. Revaluation reserve arising from revaluation of fixed assets is also a capital reserve.
4. The auditor, in many audit engagements, particularly those relating to corporate entities, may find very few changes in the capital account and/ or reserve accounts. However, the transactions in the capital and reserve accounts are normally material in amount in addition to being significant in nature and, therefore, each transaction in these accounts requires careful attention.
5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, *Audit Evidence*). In carrying out the audit of capital and reserves, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

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<sup>1</sup> Issued in January, 2006. Attention of the readers is invited to the fact that prior to the issuance of this Guidance Note, the aspect of audit of Capital and Reserves was covered by paragraphs 8.1 to 8.18 of the Statement on Auditing Practices. The Statements was withdrawn pursuant to the issuance of the Guidance Note on Audit of Payment of Dividend in August 2005.

### III.174 Auditing Pronouncements

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<i>Existence:</i>	that the recorded amounts of capital and reserves exist at the given date
<i>Occurrence:</i>	that the transactions recorded in the capital and reserve account(s) occurred during the period under audit
<i>Obligation:</i>	that the amounts appearing in the capital and reserves account(s) are in fact a liability of the entity
<i>Completeness:</i>	that there are no unrecorded transactions in respect of capital and reserves account(s)
<i>Measurement :</i>	that the transactions in the capital and reserves account(s) have been recorded at the proper amount
<i>Valuation:</i>	that the amounts recorded in the capital and reserve account(s) are recorded at appropriate carrying value
<i>Presentation and disclosure:</i>	that the items of capital and reserves have been disclosed, classified, and described in the financial statements in accordance with recognised financial reporting framework applicable to the client.

6. The principal objectives of the auditor in the examination of capital and reserves, therefore, are:

- (a) to ascertain that amounts shown in capital and reserve account(s) as at the balance sheet date are correct;
- (b) to determine that all transactions during the year, affecting owners' funds were properly authorised and recorded;
- (c) to examine whether the applicable laws and regulations and terms of issue/ agreement, if any, have been complied with; and
- (d) to verify whether these amounts have been properly classified and disclosed in the financial statements.

#### INTERNAL CONTROL EVALUATION

7. Paragraph 2 of the Standard on Auditing (SA) 400, *Risk Assessments and Internal Control*, requires the auditor to obtain an understanding of the accounting and internal controls relating to capital and reserves sufficient to plan the audit and develop an effective audit approach. Paragraph 1 of the SA 500 requires the auditor to "obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information". Paragraph 1 further states:

"Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.

Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system."

In certain cases, the client may employ a third party to carry out any of its transactions in respect of capital and/ or reserves. For example, it is quite common for listed companies to

outsource the administrative aspects related to allotment, issuance of share certificates, share transfer, maintenance of records of shareholders, etc. In such situations, the auditor, as required by Standard on Auditing (SA) 402, "*Audit Considerations Relating to Entities Using Service Organisations*", should also consider how such arrangements affect the client's accounting and internal control system so as to plan and develop an effective audit approach.

8. In the case of non-corporate entities, the auditor needs to ascertain general terms and conditions regarding contribution of capital, interest payable on capital, interest chargeable on withdrawals, limits imposed on withdrawals, etc. In respect of corporate entities, the auditor should particularly review the following aspects of internal controls relating to capital and reserves:

- (a) *Proper authorisation of transactions:* All transactions in the capital and reserves accounts such as issue of fresh shares and allotment, buy back of shares, forfeiture, making calls on the shares, should be properly authorised as required by the Companies Act, 1956. Outsourcing of any services, e.g., depository services should also be with the proper authorisation of a competent authority. The authority to sign the share certificates may be delegated to a person as per the laws applicable to the entity.
- (b) *Proper control over issue and custody of share certificates:* In case where shares are in the physical form, the auditor is required to examine that proper internal control system exists to ensure that the share certificates are pre-numbered, proper accounts are maintained for certificates cancelled due to defacement, wear out, exhaustion of cages to record transfer particulars, dematerialisation. The auditor should examine whether blank share certificates are under the lock and control of the company secretary or some other responsible officer of the entity. He should also examine whether at least one officer of the entity personally signs the share certificates issued, though other signatures can be facsimile type and whether such a signing officer also verifies the register of share certificates, wherein the issue particulars are recorded. It may be noted that share certificates are generally issued for a fixed lot of shares (marketable lot, or some other predetermined denomination).
- (c) *Allotment and call intimations etc.:* The auditor should examine whether allotment of shares and calls is done pursuant to a resolution of the Board and that proper internal controls exist for despatch of allotment advices and call letters.
- (d) *Internal control on receipts and accounting of application, allotment and call money:* Internal controls applicable for receipt and accounting of money received on application, allotment and calls need to be evaluated. Proper records should be maintained for recording the said transactions. Periodical reconciliation of bank accounts opened specially for transactions in capital account have to be made.
- (e) *Maintenance of adequate records:* The auditor should verify whether proper system of internal controls for documentation is in operation. It includes maintenance of proper and adequately detailed records in respect of the details of members, share certificate stock ledger, duplicate certificates, cancelled certificates, etc.

- (f) *Proper control over issue of instructions to depository participants:* There should exist proper controls over issue of instructions to and for execution of requests received from the depository participants for the dematerialisation/re-materialisation of shares and proper records are required to be maintained for recording such transactions.

#### INTERNAL CONTROLS RELATING TO OUTSOURCED ACTIVITIES

9. For the efficient carrying out of the day to day transactions like issue of share certificates/instructions to depository participants for the credit of shares on allotment, either on public issue or rights issue, issue of call letters, etc., authority may be delegated, at the general meeting, to registrars and share transfer agents. In such cases, the auditor should follow the procedures described by the SA 402.

#### VERIFICATION

10. Verification of capital and reserves may be carried out employing the following procedures:

- (i) examination of records;
- (ii) examination of compliance with laws and regulations and terms of issue/ contract, if any; and
- (iii) examination of presentation and disclosure.

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

#### ENTITIES OTHER THAN PARTNERSHIPS AND SOLE PROPRIETORSHIPS

##### Examination of Records

##### *Capital*

##### *Authorised Capital*

12. The authorised capital shown in the balance sheet should be checked with the Memorandum of Association in case of a company, registered byelaws in case of a co-operative society, relevant statute or the Government Order in case of a statutory corporation or other body corporate. The auditor may also refer the audited balance sheet of the immediately preceding year.

13. The minutes of the general meeting and/ or Board should be examined to see, if any, change in the capital structure has taken place since the last balance sheet and whether it is properly authorised. A company, having a share capital, in terms of the provisions of section 94 of the Companies Act, 1956 may change its share capital as follows:

- (i) increase its share capital by such amount as it thinks expedient by issuing new shares
- (ii) consolidate or divide all or any of its share capital into shares of larger amount than its existing shares

- (iii) convert all or any of its fully paid up shares into stock, and reconvert that stock into fully paid-up shares of any denomination
- (iv) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum
- (v) cancel shares which, at the date of passing of the resolution in that regard, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled

In such cases, the auditor should also examine the copy of the documents filed with the Registrar of Companies in relevant form along with the specified fee pursuant to the requirements of section 97 of the Companies Act, 1956. In addition to the situations envisaged in section 94 of the Companies Act, 1956, the auditor should also enquire whether the Central Government has, under Section 81(4) ordered or directed under Section 94A(2) of the Companies Act, 1956, the conversion of debentures or loans into share capital, resulting in an increase in the authorised capital of the company. The authorised capital may also undergo a change, as a consequence of a merger or a demerger. Similarly, in case of statutory corporations, amendments made to the statute governing the entity or the Government Order in case of other public sector bodies should be enquired into.

#### *Issued and Subscribed Capital*

14. *Issued Capital:* The following records/documents would ordinarily provide necessary evidence for issued capital:

- (a) The minutes of the general and/ or board meetings for further issue of shares, e.g., under section 81 of the Companies Act, 1956;
- (b) Offer documents, if any, filed with the Securities and Exchange Board of India (SEBI)/Registrar of Companies (ROCs) and Reserve Bank of India (RBI) in respect of permission in case of ADR/GDR issue.
- (c) Return of allotment filed with the Registrar of Companies.

15. *Subscribed Capital:* Shares subscribed in response to the issue of capital can be verified by reviewing the applications received for the subscription of shares. The subscribed capital is the capital for which the application money is received. The subscribed share capital cannot exceed the issued capital.

#### *Paid up capital*

16. Periodical reconciliation of outstanding shares held in demat and physical form as on book closure/ record date should also be done.

17. The auditor should review the minutes books of Board of Directors and the members and also any amendments made to the statutory register to ascertain whether any changes have taken place in the capital of the entity, for example –

### III.178 Auditing Pronouncements

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- A. Increase in capital due to:
- (i) Fresh issue of shares/ADR/GDR.
  - (ii) Allotment of shares pursuant to merger/amalgamation or acquisition of property or services.
  - (iii) Part/full conversion of loans or debentures
  - (iv) Allotment of shares pursuant to exercise of option either by the promoters or the employees or other option holders.
  - (v) Allotment of Bonus shares
  - (vi) Rights issue
- B. Decrease in capital due to:
- (i) Forfeiture
  - (ii) Buy-back of shares
  - (iii) Redemption of redeemable preference shares
  - (iv) Reduction of capital
  - (v) Surrender of shares as in the case of Co-operative societies
  - (vi) De-merger

18. A list of members, together with shares held by them and the amounts paid-up thereon, should be available with the company/entity as at the balance sheet date and the aggregate of these should agree, with the details of capital shown in the balance sheet. A copy of the annual return for the previous year filed under the Companies Act, 1956 or any other statute or a list of members prepared for issuing dividend warrants may also be examined. If the auditor chooses to verify the list of members as per the annual return or list of members prepared for issuing dividend warrants, he should also check the reconciliation with the amount as at the balance sheet date, with the changes occurred during the period from the date of balance sheet and record date/ book closure date. Where the registration work is carried out by independent specialised agencies, a certificate, containing the list of members, the number of shares held, including those in the demat form and physical form and amount paid up on these shares and calls in arrears, if any, should be obtained and reconciliation of the particulars with the amount credited as paid up in the share capital account of the General Ledger be checked on a test basis.

19. If a change in the capital has taken place during the year under audit, inquiries should be made to ascertain that it is properly authorised in the manner prescribed by the Articles and appropriate resolutions have been passed with requisite majority.

20. The auditor should enquire whether the Central Government has passed any order under Section 108 or Section 250 of the Companies Act, 1956 freezing the voting rights of any shareholders. It may be noted that there are provisions in the Banking Regulation Act, 1949

limiting the voting rights of a person. Similarly, the Co-operative Societies Act, 1912 provides for issue of two types of shares, one having voting rights and other not having voting rights. The Companies Act, 1956 also provides for issue of shares with non voting rights. These matters have a bearing while examining the validity of the resolutions passed by the members of the entity. The auditor should, therefore, also check that the classes of shares have been appropriately disclosed.

#### *Subscription in Cash and Kind*

21. The law requires a distinction to be made between shares subscribed for in cash and shares subscribed for consideration other than in cash. Shares subscribed for in cash should include only the following kinds of subscription: -

- (a) where the subscription amount is received either in cash or by cheque;
- (b) where the amount is adjusted against a *bona fide* debt payable in money at once by the company.

There might be situations where a company has taken a loan under a stipulation that in case of default in repayment of the loan, the loan would get converted into shares. In such a situation, on a default in repayment of the loan by the company, if the loan gets converted into shares in the company, such shares would be considered as having been allotted for cash. Where shares are allotted against credit balance in a person's account, inquiry should be made as to how the credit balance in that account has arisen, whether it was for a valid consideration and whether the amount was due for payment at the time of issue.

22. The Department of Company Affairs<sup>2</sup> has clarified through its circular No. 8/32(75) 77-CL-V dated 13th March, 1978, that a genuine debt adjusted against the amount receivable towards share capital can be treated as amount paid in cash. The extracts from the advice received from an eminent Counsel in this regard are given as **Appendix A** to this Guidance Note.

23. Where the subscription for share capital is paid into a bank account in a foreign country, it should be verified that the amount deposited in the foreign currency is in accordance with the terms of issue and such an amount as, if remitted into India on the day on which the deposit is made in the foreign country, would have realised in Indian rupees a sum equal to the amount credited as paid up and premium, if any, on the shares. The auditor should verify that the guidelines issued by SEBI for inviting, collecting and recording of foreign capital have been complied with by the company. The foreign exchange fluctuations, if any, should be accounted for in the balance with bank in accordance with the provisions of Accounting Standard 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*.

24. *Issue of Shares for Consideration Other than Cash:* Shares may also be issued for a consideration other than cash, e.g., for supply of machinery or technical know-how. The auditor should examine the underlying agreement in respect of the same and verify whether the agreement has been properly approved. The auditor should treat the shares issued for

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<sup>2</sup> Now known as the Ministry of Company Affairs.

### III.180 Auditing Pronouncements

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consideration other than cash separate from those issued against cash in his audit approach. He needs to verify that the consideration for which shares are issued, *viz.*, supply of machinery or technical know-how is *prima facie* fully received.

25. Further, as per the provisions of section 75 of the Companies Act, 1956, whenever company having a share capital makes any allotment of its shares, the company has to comply with the following conditions:

- i. It has to file with the Registrar of Companies, a return of the allotment, stating the number and nominal amount of shares comprised in the allotment, the names, addresses and occupations of the allottees, and the amount if any, paid or due and payable on the shares.
- ii. In case of shares allotted for other than cash, it has to produce before the Registrar, *inter alia*, a contract in writing, constituting the title of the allottee to the allotment together with any contract of sale, or a contract for services or other consideration in respect of which allotment was made.

26. The auditor may examine the following records to the extent they are applicable to the particular circumstances, in case of increase in paid-up capital:

- (a) Final price determined in case of offer through book building process<sup>3</sup>.
- (b) Scheme of compromise or arrangement as referred to in section 394 of the Companies Act, 1956, approved by the Court.
- (c) Compromise proposal with creditors and the consequential Order of the Court or an Order of Central Government under Section 397 of the Companies Act, 1956.
- (d) Procedure and terms of reissue of forfeited shares.

27. In case the payment is allowed to be made on allotment and/ or also in instalments of one or more calls, the auditor has to verify the resolution of the Board for making calls, amount received against the calls and the posting of the amount to the correct member's account/folio. A schedule of allotment money and a schedule for each call have to be verified on test check basis and reconciled with total amount received and due on allotment and each call. If the accounting work relating to the share capital is outsourced to a Registrar and Share Transfer Agent, the auditor should follow the principles enunciated in SA 402. If the Articles of Association permit and the terms of issue state that in the event of delay in payment of either allotment money or calls, the investor has to pay interest, the auditor should verify whether such interest is collected and properly accounted for in the books of account. The auditor should review the schedules of calls in arrears and calls in advance, and ensure that interest

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<sup>3</sup> *Book Building Process*: Listed companies can also issue shares through Book Building Process. Book Building is a process wherein the issuer of securities asks investors to bid for his securities at different prices. These bids are within an indicative price-band, decided by the issuer. Here, investors bid for different quantity of shares, at different prices. Considering these bids, the issuer determines a cutoff price, which is the price at which the securities are allotted. SEBI has issued guidelines on issue of shares through Book Building Process. The auditor has to verify whether the company has complied with all the guidelines issued by SEBI in this regard and also that the basis of determination of the floor price and the final price by the company is consistent with the provisions in that regard.

is provided in accordance with the Articles of Association, Offer Documents/Terms of Issue. The auditor may verify the Board Resolution, if any, for waiver of interest on calls in arrears. Interest on calls in arrears may be accounted at the time of receipt, with proper disclosure in the balance sheet for deviating from the accrual principle. The schedule of calls in arrears should show separately the amounts, if any, due from the directors. Similarly, the auditor should also examine the payment of interest on calls received in advance, if any, made by the company. He should verify whether any such payment of interest on calls received in advance is permitted by the articles of association of the company. He should also examine the Board resolution in this regard.

28. In case shares are issued at discount, the auditor has to verify the compliance of Section 79 of the Companies Act, 1956.

29. Generally, employees are offered shares at a price lesser than the market rate. Sections 79 and 79A of the Companies Act, 1956 and SEBI (Employee Stock Option Scheme and Employees Stock Purchase Scheme) Guidelines, 1999 (ESOS and ESPS), Employee Stock Option Scheme for Public Sector Enterprises and others statues governing the entity have to be complied with. Transactions relating to options are to be accounted as required by the said scheme or the Accounting Standards and provisions of any relevant statute, if any, in force, on treatment of discount etc., on ESOS/ESPS.

30. *Issue of Sweat Equity*: Section 79A of the Companies Act, 1956 deals with the issue of sweat equity by the company to its employees and directors, at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. SEBI has also issued SEBI (Issue of Sweat Equity) Regulations, 2002 for issue of the sweat equity by the listed companies. The issue of sweat equity by unlisted companies is governed by Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003<sup>4</sup>. The auditor must verify that if the company has issued any sweat equity, whether the provisions of Section 79A of the Companies Act, 1956 and the Rules applicable to the company, depending whether listed or not, have been complied with.

31. Companies are now allowed to buy-back their own shares. Sections 77A and 77B of the Companies Act, 1956 lay down the conditions and procedures for buy-back of the shares of a company. In case of private limited and unlisted companies, the Private Limited Company and Unlisted Public Limited Company (Buy-back of Securities) Rules 1999, and in case of listed companies, SEBI (Buy-back of Securities) Regulations, 1998 have to be complied with. The auditor should verify particularly that the funds employed for the buy-back are from the resources as permitted by the law. The reconciliation of entries in escrow account or the bank account separately opened for payment of purchase consideration have to be verified with the number of shares bought back and price paid. The auditor should also verify the entries made in the concerned books/registers with regard to destruction of share certificates and extinguishments of dematerialised shares and a reconciliation of these two to arrive at the total number of securities purchased under buy- back process.

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<sup>4</sup> Issued by the Ministry of Company Affairs *vide* Notification number GSR 923E dated 4<sup>th</sup> December, 2003.

32. Registered Byelaws of the Co-operative Societies specify the terms and conditions for surrender of all or certain class of shares. Generally, surrender of shares is allowed only at par. The auditor has to verify the certificates surrendered vis-à-vis the payment made and the entries made in the Register of members, share certificate ledger etc.

33. In case of reduction of capital is by way of reduction of the nominal value of the shares, either by canceling unpaid portion of the partly paid shares, or extinguishing some part of the paid up capital, the auditor has to verify that the High Court Order under Section 100 of the Companies Act, 1956 for reduction of capital has been complied with. Further, he has to verify the share certificates surrendered and the statement of corresponding new share certificates issued. In case reduction is achieved by canceling fully paid shares proportionately, the auditor should also verify the surrendered shares/issue of stickers/intimation to the depositories *vis-à-vis* the amount reduced.

34. It may be noted that the buy-back of shares under Section 77A and redemption of redeemable preference shares under Section 80 do not attract the provisions of Section 100 of the Companies Act, 1956.

#### *Application Money*

35. Schedule VI to the Companies Act, 1956 does not prescribe the manner of disclosure of share application money. However, as a matter of prudence and better disclosure, share application money should be shown separately between "Share Capital" and "Reserves & Surpluses" in the Balance Sheet till the time share application money is transferred to the Share Capital Account. However, in the following situations, the share application money would be disclosed separately under the head "Current Liabilities" in the Balance Sheet:

- invalid or revoked applications;
- excess application money received due to over subscription; and
- when minimum subscription stated in the offer document is not received.

36. The auditor has to verify whether application money stated is fully backed by the share application forms/certificate from the Share Transfer Agent and applications are received pursuant to a resolution of the appropriate authority for issue of capital. Amount received without satisfying any of the above conditions should be refunded by the company.

37. Share application money accepted by the company, if not backed by the application form/Registrar's certificate alongwith the resolution of the Board as stated above, should be treated as unsecured loan. The auditor should verify that the application money received in excess of capital offered for subscription, if any, has been stated under Current Liabilities. The auditor may examine the reasonableness of the period for which the share application money remains pending allotment.

38. In case of refund of excess application money/revoked applications, the auditor should verify the same and apply the similar audit procedures as applied for audit of any other liability. The auditor should also verify whether the company has complied with the Guidelines prescribed by SEBI with regard to time schedule and payment of interest in case of delay in such refunds.

*Calls Received in Advance*

39. The auditor should examine whether the calls received in advance and payment of interest, if any, thereon is in accordance with the provisions contained in the Articles of Association in this regard. Schedule of calls received in advance is to be reviewed with reference to the amounts deposited in the bank.

40. Interest, if any, paid on the amount received in advance of calls should be verified and the audit procedure to be employed is same as in case of payment of interest on borrowings.

*General*

41. The auditor should examine whether proper accounts have been maintained with regard to amounts received on application, allotment and calls and the payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where shares are issued at a premium, the auditor should ensure that such sums are accounted for separately. In case of buy back, reissue or redemption of preference shares and reduction of capital by payment of money, the auditor should examine whether these have been properly accounted and duly reconciled with payments made for the same.

42. Proviso to section 383A of the Companies Act, 1956 requires certain companies to obtain a certificate of compliance with the provisions of the Companies Act, 1956 from a practicing company secretary. The auditor of such companies may review the same.

*Reserves*

43. Reserves should be distinguished from provisions. For this purpose, reference may be made to the definitions of the expressions, "provision" and "reserve", etc., in the Guidance Note on Terms Used in Financial Statements issued by the Institute. The definition of the term "reserve" as given in the said Guidance Note is explained in paragraph 3. It is important to remember that any amount provided in excess of the requirements is in the nature of reserve and should be shown as such.

44. It is also necessary to make a distinction between capital reserves and revenue reserves in the accounts. A Revenue Reserve is ordinarily available for distribution as dividend.

45. Reserves may also contain amount received from the Government. These grants may be in the nature of promoters' contribution or related to any specific fixed asset. The auditor should verify that the principles of Accounting Standard 12, *Accounting for Government Grants* for recognition, presentation, refund, if required, and disclosure of the grant have been appropriately complied with.

46. A reserve account is styled as Reserve Fund only when such reserves are represented by specifically earmarked assets or investments.

47. In case of amalgamations and mergers, reserves of the amalgamated /merged company have to be treated as prescribed in Accounting Standard 14, *Accounting for Amalgamations* issued by the Institute. However, the auditor, especially in cases of amalgamations/ mergers, may come across a situation where the relevant Court/ Tribunal has made an order sanctioning an accounting treatment different from that prescribed by an Accounting Standard.

In such a situation, the attention of the members is drawn to the announcement of the Council of the Institute in this respect. The Council has recommended that the following disclosures be made in the financial statements for the year in which different treatment has been given:

- (i) A description of the accounting treatment made alongwith the reason that the same has been adopted because of the Court/ Tribunal order.
- (ii) Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.
- (iii) The final impact, if any, arising due to such a difference.

### ***Capital Reserves***

#### *Capital Redemption Reserve*

48. In terms of the provisions of sections 77A and 80 of the Companies Act, 1956, if the company redeems the preferential share capital or buys back its own shares, using the retained earnings, the amount equivalent to the nominal value of the shares redeemed/bought back have to be transferred to the capital redemption reserve, and such reserve can be utilised only for issue of bonus shares to the members of the company.

#### *Securities Premium Account*

49. Any premium realised on issue of securities should be transferred to Securities Premium Account and utilised only for the purposes laid down in section 78 of the Companies Act, 1956.

#### *Government Grants*

50. Grants, contributions and subsidies received from Government specifically for acquisition of assets have to be treated and disclosed in the financial statements as laid down in Accounting Standard 12, issued by the Institute.

#### *Revaluation Reserve*

51. Reserves arising out of revaluation of fixed assets are to be transferred to the Revaluation Reserve account. The treatment and utilisation of these reserves is governed by the "Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets" and "Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares" issued by the Institute.

#### *Statutory Reserves*

52. Section 17 of the Banking Regulation Act, 1949 and certain provisions in the Co-operative Societies Act, 1912 provide for creation and utilisation of certain specific reserves. Laws governing other entities may contain similar provisions as to the creation and utilisation of such reserves. The regulators may also direct the entities to create some specific reserves, for example, the Reserve Bank of India has directed all banking companies to create and transfer certain amount of profits earned on trading of investments to Investment Fluctuation Reserve and has also stipulated the purpose for which such reserve can be utilised. The

auditor should familiarise himself with such regulatory directions with respect to creation and utilization of such specific reserve and verify compliance therewith.

### ***Revenue Reserves***

53. A revenue reserve is a reserve, which is available for distribution as dividend. The auditor should examine the legal provisions governing the entity with regard to transfer of certain percentage of profits to reserves, for example, the requirements of section 205 (2A) of the Companies Act, 1956, the Reserve Bank of India Directions in case of Non Banking Financial Companies, etc.

54. Certain other statutes may require transfer of profits to reserves. For example, the Income-tax Act, 1961 may require creation of certain reserves and provide for rules for utilisation of such reserves to claim certain fiscal benefits. The auditor should examine the need for transfer of profits to reserves and utilisation of such transfers.

### **Examination of Compliance with Laws and Regulations**

55. Standard on Auditing (SA) 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* requires that "when planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognise that non compliance by the entity with laws and regulations may materially affect the financial statements." The auditor should therefore acquire sufficient knowledge of the legal and regulatory framework within which the client operates. This assumes added importance in cases of audit of capital and reserves of companies since the matters relating to the share capital and reserves are governed by the provisions of the Companies Act, 1956, especially the provisions contained in sections 69 to 116, section 177C, section 205(2A) of the said Act. For example, sections 69 to 116 of the Companies Act, 1956 regulate the matters relating to issue and allotment of shares, section 205 (2A) and section 177C of the Companies Act, 1956 contain provisions relating to creation and utilisation of certain reserves and section 187C deals with the situation where the beneficial owner of the shares of the company is different from the person whose name is appearing in the shareholders' register of the company. Guidelines issued by the Securities and Exchange Board of India from time to time also contain the matters relating to the issue and allotment of shares in case of public offer and substantial acquisition of shares in case of existing listed companies. Moreover, the Articles of Association of the entity may also have provisions relating to share capital and reserves. The Companies Act, 1956 requires compliance with the Articles of Association in so far as they are not contradictory to the provisions of the Act. Hence, it is very important to verify the compliance with the laws and regulations governing the entity.

56. The State Co-operative Societies Acts may have conditions as to minimum paid up capital and also minimum number of members for co-operative societies and with regard to creation and utilisation of various reserves. Statutes governing the entity may contain similar provisions with regard to the number of members and minimum amount of capital. The auditor should be familiar with the laws governing the entity. The auditor has to carefully examine the compliance of such legal requirements.

57. The auditor has to examine the compliance with the various rules and regulations, for example:

- (a) Government Order, if any, the Memorandum and the Articles of Association of the company or the Rules and Regulations governing the entity.
- (b) Terms of issue attached or subsequently approved in case of conversion of loans or convertible preference shares.
- (c) Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and Guidelines on Euro Issues.
- (d) Rules and Regulations relating to issue and buy back of ADR/GDR.
- (e) Chapter XIII of SEBI (Disclosure and Investor Protection) Guidelines 2000 in case of preferential issue.
- (f) Unlisted Public Companies (Preferential Allotment) Rules, 2003.
- (g) Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003.
- (h) Any other Rules and Regulations prescribed by Government/SEBI from time to time.

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

58. The laws governing the entity may prescribe the format for disclosure of information relating to the Capital and Reserves in its Balance Sheet. For example, the Companies Act, 1956, the Banking Regulation Act, 1949, the Electricity Act, 2003 and Insurance laws prescribe the format of Balance Sheet and the manner of disclosure of the capital and reserves in the financial statements. The auditor should examine compliance with such disclosure requirements and adequacy thereof. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same are complied with, for example, SEBI requires that in case of public issue and preferential issue of shares and/or partly/fully convertible debentures, purpose for which these monies are utilised and the manner in which the unutilised money is invested should be disclosed. Sometimes, it may be necessary to disclose the information either in the Significant Accounting Policies and Notes on Accounts to clarify the matters, for example, any employee options outstanding, etc. The auditor should examine such necessity and consider whether appropriate disclosures such as those listed below have been made:

- Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) with or without payment being received in cash
- Aggregate number and class of shares allotted as fully paid by way of bonus shares
- Aggregate number and class of shares bought back
- Source of issuance of bonus shares during the year, if any
- Preference Share Capital, including terms of redemption or conversion
- Shares with differential rights

**SPECIAL CONSIDERATIONS APPLICABLE TO PARTNERSHIP ENTITIES**

59. The most significant document underlying the partnership form of organisation is the Partnership Deed.

60. The Partnership Deed generally provides the capital required to be contributed by the partners and their respective share in profits and losses and interest, if any, on the capital contributed or balances to their credit. The Partnership Deed may also provide for the treatment of excess capital contributed by any partner and their respective rights relating to the withdrawals from capital/drawing accounts.

61. It may be possible that one or more partners contributes the capital in kind rather than in cash. For example, the premises required for the business may be provided by a partner as his capital contribution. If such contributions are in kind at the time of admission of the partners, the value of such assets is generally mentioned in the Partnership Deed. If the value is not mentioned in the Partnership Deed, the auditor may request for a declaration of the value in writing by all the partners. He should also obtain necessary audit evidence for supporting the valuation.

62. The partnership deed may also provide for fixed capital contribution and timing of contribution by each partner. The auditor should examine whether the capital contributed by each of the partners is in accordance with the Partnership Deed and the capital is maintained at the level mentioned in the Partnership Deed throughout the period of audit.

63. If the Partnership Deed places any restrictions on the drawings of the partners, the auditor should examine whether the drawings have been within the permissible limit.

64. The auditor has to verify the correctness of the interest, if any, credited or debited to the partners' capital or drawings account.

65. Generally, remuneration, interest on capital, interest on drawings, profits or losses are adjusted in the capital accounts or the drawing accounts of the partners, and Reserve accounts are not maintained in case of partnership accounts. However, if fiscal or any other law require any reserve has to be created for claiming any benefit, a reserve with appropriate title may be created out of the profits of the firm. The rules for utilisation of the reserve may be provided in the relevant laws. In such event, the auditor should examine the compliance with the same. Sometimes, the partners may decide to create and utilise certain reserves due the exigencies of the business, in which case the auditor has to verify the compliance of the decision of the partners. In case the entity has not complied with the prescribed reserve utilization requirements, he should consider the effect of the same on his audit report in terms of the principles laid down in the SA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

66. Special Reserves, created to meet the requirements of any law, may be credited to the Partners' Capital Accounts on fulfillment of such statutory requirements or the terms of creation of such reserves.

67. Government grants and subsidies received shall have to be accounted for in accordance with Accounting Standard 12.

68. Where either investments or drawings have come from Non Resident Indians or foreign sources involving foreign currency, the auditor has to verify the compliance of RBI regulations as well as the provisions of the Foreign Exchange Management Act, 1999 in this regard.

69. All transactions in the partners' capital account and drawings account have to be vouched for their correctness.

70. The auditor has to verify that the distribution of profit/loss is as per the terms of Partnership Deed. It may be noted that if any minor is admitted to the benefits of partnership, no loss should be apportioned to the share of minor.

71. If a partner dies/retires during the year, the partnership entity may prepare accounts up to the date of such death/retirement to ascertain the claim of heirs/retiring partner. In such event, the auditor has to verify the apportionment of the profit/loss for both the periods.

#### **SPECIAL CONSIDERATIONS APPLICABLE TO A SOLE PROPRIETARY ENTITY**

72. The audit of capital account of the sole proprietor poses considerable problems, as the capital account is generally maintained as a current account. Generally, the entries in the capital account are many, when compared with other forms of entities. The capital introduced by the proprietor in the entity may be in cash or in kind. The introduction of capital can take place at number of times, depending upon the need for the working capital in the entity. Similarly, the drawings are made for various personal expenses.

73. It may also be possible that the personal expenses of the proprietor are booked in the accounts of the business without appropriately reflecting them in those accounts.

74. Generally, internal control procedures are inadequate or absent in many sole proprietary entities. Hence, the auditor should be careful while examining the accounts of such entity. Though the auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both small and large entities, however, many internal controls which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures. He should apply his professional judgment based on the knowledge of the business he has acquired to determine whether the expenditure recorded is in fact relevant and appropriate to the business and also all expenditures are recorded in the books of account.

75. The auditor should examine the nature of assets included in the balance sheet of the entity and verify whether such assets are relevant and appropriate to the nature of the business and recorded at fair value.

76. Generally profits or losses are adjusted in the capital account or the drawings account of the proprietor, and reserve accounts are not maintained in case of sole proprietorship accounts. However, if fiscal laws require any reserve to be created for claiming any fiscal benefit, a reserve account with appropriate title may be created out of the profits of the firm. The rules for utilisation of the reserve account may be provided in the same fiscal laws. In such event the auditor should examine the compliance with such laws.

77. Special Reserves created, if any, pursuant to fiscal laws, upon fulfillment of the terms of such reserves, have to be transferred to the capital account of the sole proprietor.

78. Government grants and subsidies received shall have to be accounted for in accordance with Accounting Standard 12.

### MANAGEMENT REPRESENTATIONS

79. The auditor should obtain from the management of the entity, a written representation on significant aspects of capital and reserves accounts, *viz.*, that all the transactions in the capital and reserves have been recorded and recorded at correct values; that there are no unrecorded transactions in the capital and reserves accounts, that the year end balances (including any notes to the accounts in respect thereof) of the capital and reserves accounts have been appropriately presented and disclosed in accordance with applicable financial reporting framework, in the financial statements, that the management has complied with all the applicable rules and regulations while undertaking transactions relating to capital and reserves.

### DOCUMENTATION

80. The auditor should maintain adequate working papers documenting significant aspects of audit such as:

- (a) the nature, timing, extent and results of the audit procedures performed to comply with Standards on Auditing and applicable legal and regulatory requirements;
- (b) the audit evidence obtained;
- (c) the conclusions reached on significant matters ; and
- (d) in relation to audit procedures designed to address identified risks of material misstatement, conclusions that are not otherwise readily determinable from the procedures performed or audit evidence obtained.

However, it may be noted that the extent of documentation is a matter of professional judgment since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

### *Appendix A*

#### **Extracts from Counsel's opinion referred to in Para 22 – "Subscription in Cash and Kind"**

"The ratio of Spargo's case is that if there is on the one side a bona-fide debt payable in money at once by the company (hereinafter called "debt"), and on the other side a bona-fide

### III.190 Auditing Pronouncements

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liability to pay money on allotment of shares, so that if bank notes are handed from one side of the table to other in payment of calls, they may legitimately be handed back in payment of the debt. The law does not make it necessary that the formality should be gone through of the money being handed over be taken back again, and if the two demands are set off against each other the shares have been paid for in cash. This is still good law and on facts similar to those of Spargo's case it would be right for a company to show in its accounts the shares as having been allotted for cash.

It is the necessary implication of Section 227(1A)(f) that shares may be correctly stated to have been allotted for cash even though cash may not have been actually received in respect of such allotment ..... If the Auditors find that the case is covered by the ratio of the decision in Spargo's case, no comment would be required from the Auditors and the statement in the Balance Sheet and other accounts that the shares were allotted for cash must be accepted as correct, regular and not misleading, although no cash had been actually received by the company.....

The function of Section 75(1) is merely to impose an obligation on the company to file a Return of the Allotments with the Registrar. Now, the expression "share allotted for cash" is an ambiguous expression. It may mean shares allotted for cash actually received by the Company, or it may mean shares allotted for cash not actually received but adjusted against a debt. In order that this ambiguity may be removed and the Registrar may know the precise factual position, Section 75(1)(a) requires that in the Return of Allotments to be filed with the Registrar shares should not be shown as having been allotted for cash if cash has not been actually received. This, however, does not prevent the company from stating in the Return that shares not shown in the Return as having been allotted for cash were in fact allowed against adjustment of a debt, and consequently such shares would be shown in the company's accounts as having been allotted for cash."

## GUIDANCE NOTE ON AUDITING OF ACCOUNTS OF LIQUIDATORS\*

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### AUDIT REPORT UNDER SECTION 551 OF THE COMPANIES ACT, 1956

Members of the profession are called upon to conduct the audit of the accounts submitted by a Liquidator in a voluntary winding-up under Section 551. There are no statutory provisions in regard to the manner of conducting such audit, nor is there any statutory provision regarding the form in which the auditors' report is to be submitted after such an audit under Section 551. The Research Committee has considered this question in all its aspects and its recommendations in this connection are outlined below:

First, the professional skill and audit procedures to be applied in case of an audit under Section 531 would be similar to those applied in the case of the normal audit of a company.

Secondly, there should be a fair measure of uniformity in the reports submitted by auditors conducting an audit under Section 551 of the Companies Act, 1956. The Research Committee recommends that the report of the auditor may be on the following lines:

- (a) Whether he has obtained all the information and explanations, which to the best of his knowledge and belief, were necessary for the purposes of his audit,
- (b) Whether in his opinion, proper books of account as required by the Companies Act, 1956 and Companies (Court) Rules, 1959 have been kept by the Liquidator, so far as appears from his examination of these books,
- (c) Whether the Liquidator's Account relating to realisations and disbursements is in agreement with the books and records produced before him,
- (d) Whether in his opinion, and to the best of his information and according to the explanations given to him, the Liquidator's Account including Annexure I (excepting items included in I (a) in so far as they relate to estimates of the Liquidator and items 4, 5, 6 and 7), Annexure II, III, IV and V, give the information required by the Companies Act, 1956, and the Companies (Court) Rules, 1959 in the manner so required and give a true and correct view of the realisations and disbursements of the Liquidator.

Thirdly, "in order to establish a healthy convention, the Council recommends that, where a chartered accountant acts as a liquidator, the statements of accounts to be filed under Section 551(1) of the Companies Act, 1956, should be audited by a qualified chartered accountant other than the chartered accountant who is the liquidator of the company".

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\* This is an integrated note of the notes published in "The Chartered Accountant", Feb. 1962, p. 289, and Aug. 1963, p.98.

## GUIDANCE NOTE ON AUDIT OF CONSOLIDATED FINANCIAL STATEMENTS\*

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### INTRODUCTION

1. The Council of the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 21 'Consolidated Financial Statements' which lays down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented for a group of entities under the control of a parent. A 'parent' is an entity that has one or more subsidiaries. A group comprises a parent and its subsidiaries. Thus, consolidated financial statements are the financial statements of a group presented as those of a single entity. AS 21 is applicable to a parent that presents consolidated financial statements. In other words, whenever a parent decides to prepare and present consolidated financial statements, it should do so in accordance with the requirements of Accounting Standard (AS) 21, Consolidated Financial Statements.

2. Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, explanatory material that form an integral part thereof, and also consolidated cash flow statement (in case a parent presents its own cash flow statement). Consolidated financial statements are presented, to the extent possible, in the same format as adopted by the parent for its separate financial statements.

3. An entity which prepares the consolidated financial statements, either under any law or regulation governing the entity or *suo motu*, might be required to or otherwise engage a member for conducting the audit of consolidated financial statements.<sup>1</sup> The auditor of the consolidated financial statements may not necessarily be the auditor of the separate financial statements of the parent or one or more of the components<sup>2</sup> included in the consolidated financial statements. However, a law or regulation governing the entity may require the

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\* Issued in September, 2003. With the issuance of this Guidance Note, the Format of Auditor's Report to the Board of Directors on Consolidated Financial Statements which was published in March, 2002 issue of 'The Chartered Accountant' stands withdrawn.

<sup>1</sup> The Securities and Exchange Board of India, *vide* its circular SMDRP/Policy/Cir.44/01 dated August 31, 2001 has amended clause 32 of the listing agreement which now requires the listed companies to publish consolidated financial statements in addition to the separate financial statements in its annual report. The amended clause further requires that the statutory auditors of the company should audit the consolidated financial statements. The filing of consolidated financial statements with stock exchanges has also been made mandatory.

Similarly, the Reserve Bank of India, *vide* its circular no. DBOD No. BP.BC. 72/21.04.018/2001-02 dated February 25, 2003 have required the banks to prepare consolidated financial statements to facilitate consolidated financial supervision.

<sup>2</sup> Paragraph 8 of Standard on Auditing (SA) 600, "Using the Work of Another Auditor", defines "components" as a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

consolidated financial statements to be audited by the statutory auditor of the entity. This Guidance Note provides guidance on the specific issues and audit procedures to be applied in an audit of consolidated financial statements.

#### **DEFINITIONS**

4. Various terms used in this Guidance Note, have the same meaning as in Accounting Standard (AS) 21, 'Consolidated Financial Statements', Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements' and Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures' respectively.

#### **Responsibility of Parent**

5. The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent. This includes:

- (a) identifying components, and including the financial information of the components to be included in the consolidated financial statements;
- (b) where appropriate, identifying reportable segments for segmental reporting;
- (c) identifying related parties and related party transactions for reporting;
- (d) obtaining accurate and complete financial information from components; and
- (e) making appropriate consolidation adjustments.

6. Apart from the above, the parent ordinarily issues instructions to the management of the component specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, and related parties and related party transactions, and a reporting timetable.

#### **Responsibility of the Auditor of the Consolidated Financial Statements**

7. The auditor of the consolidated financial statements is responsible for expressing an opinion on whether the consolidated financial statements are prepared, in all material respects, in accordance with the financial reporting framework under which the parent prepares the consolidated financial statements.

8. Therefore, the auditor's objectives in an audit of consolidated financial statements are:

- (a) to satisfy himself that the consolidated financial statements have been prepared in accordance with the requirements of Accounting Standard (AS) 21, Consolidated Financial Statements, Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures; and
- (b) to enable himself to express an opinion on the true and fair view presented by the consolidated financial statements.

9. Standards on Auditing, Statements and Guidance Notes on auditing matters issued by the Institute of Chartered Accountants of India apply in the same manner to audit of consolidated financial statements as they apply to audit of separate financial statements. It means that the auditors, while conducting the audit of consolidated financial statements are, *inter alia*, expected to:

- (a) plan their work to enable them to conduct an effective audit in an efficient and timely manner;
- (b) obtain an understanding of the accounting and internal control systems sufficient to plan the audit and determine the nature, timing and extent of his audit procedures. Such an understanding would help the auditors to develop an effective audit approach;
- (c) use professional judgement to assess audit risk and to design audit procedures to ensure that the risk is reduced to an acceptable level; etc.

**Audit Considerations**

10. The following features of consolidated financial statements have an impact on the related audit procedures:

- (a) The consolidated financial statements are prepared on the basis of separate financial statements of the parent and its subsidiaries and associates and/or joint ventures, using the consolidation procedures prescribed by Accounting Standard (AS) 21, "Consolidated Financial Statements", Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements" and Accounting Standard (AS) 27, "Financial Reporting of Interests in Joint Ventures"; and
- (b) The auditor of the consolidated financial statements has to use the work of other auditors unless the auditor of consolidated financial statements is not the auditor of the other components of the group. This may, however, not be true in all cases.

11. The consolidated financial statements are prepared using the separate financial statements of the parent, subsidiaries, associates and joint ventures and also other financial information, which might not be covered by the separate financial statements of these entities. The 'other financial information' would include disclosures to be made in the consolidated financial statements about the subsidiaries associates and joint ventures, proportion of items included in the consolidated financial statements to which different accounting policies have been applied, adjustments made for the effects of significant transactions or other events that occur between the financial statements of subsidiaries, associates or joint ventures and the parent, as the case may be, etc. Thus, this 'other financial information' would be required to be additionally generated.

12. When an auditor accepts the audit of consolidated financial statements, the auditor should assess whether based on his work alone he would be able to express an opinion on the true and fair view presented by the consolidated financial statements. If the auditor is of the view that his own participation may not be enough or sufficient, he should consider using the work of 'other auditors'.

13. Such 'other auditors' might be the auditors of the separate financial statements of one or more of the components of the consolidated financial statements or the auditors appointed specifically for assisting the auditor of the consolidated financial statements (the principal auditor).

14. Where the statutory auditors of one or more of the components of the consolidated financial statements are also requested to assist the principal auditor, the work to be performed by such statutory auditors for use by the principal auditor would constitute an assignment separate from the assignment to conduct the statutory audit of the respective component.

15. The Standard on Auditing (SA) 200, 'Basic Principles Governing an Audit', states (paragraph 9):

"When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance".

16. Standard on Auditing (SA) 600, 'Using the Work of Another Auditor' establishes standards when an auditor, reporting on the financial statements of an entity (the group—in the case of consolidated financial statements), uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity. The principal auditor, if he decides to use the work of another auditor in relation to the audit of consolidated financial statements, should comply with the requirements of SA 600.

17. While complying with the requirements of SA 600, 'Using the Work of Another Auditor', the principal auditor should keep the following under consideration:

- (a) When planning to use the work of another auditor, the principal auditor is not required to consider the professional competence of the other auditor if the other auditor is a member of the Institute of Chartered Accountants of India.
- (b) 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 audit of consolidated financial statements. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:
  - (i) The principal auditor should determine the information/assurance required by the other auditor; this emanates/precludes the principal auditor's determination of how the work of the other auditor would affect the audit of consolidated financial

statements, for example, the information required from the auditor of a subsidiary would be different from that required from the auditor of a joint venture.

- (ii) 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 areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the timetable for completion of audit. It may, however, be noted that the principal auditor, if using the work of the auditors of one or more of the components unless such other auditors are specifically appointed for the purpose, should not enlarge the scope of the audit of the separate financial statements of the subsidiary or component to be included in the consolidated financial statements. Thus, the instructions that are to be issued should be confined to the other information required for consolidation.
- (iii) Advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

#### **Auditing the Consolidation**

18. Before commencing an audit of consolidated financial statements, the auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. The auditor should make plans, among other things, for the following:

- (a) understanding of accounting policies of the parent, subsidiaries, associates and joint ventures;
- (b) determining the extent of use of other auditor's work in the audit;
- (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
- (d) coordinating the work to be performed.

19. A parent which presents consolidated financial statements is required to consolidate all subsidiaries, include all associates and jointly controlled entities in the consolidated financial statements other than those for which exceptions have been provided in the relevant Accounting Standards.

20. The auditor should obtain a listing of subsidiaries, associates and joint ventures included in the consolidated financial statements. The auditor should review the information provided by the management of the parent identifying the subsidiaries, associates and joint ventures. The auditor should verify that all the subsidiaries, associates and joint ventures have been included in the consolidated financial statements unless a subsidiary, associate or joint venture meets a criterion for exclusion. In respect of completeness of this information, the auditor should perform the following procedures:

- (a) review his working papers for the prior years for the known subsidiaries, associates and joint ventures;

- (b) review the parent's procedures for identification of subsidiaries, associates and joint ventures;
- (c) review the investments to determine the shareholding in other entities;
- (d) review the joint venture and other relevant agreements entered into by the parent;
- (e) review the statutory records maintained by the parent, for example registers under section 302, 372A of the Companies Act, 1956.

The auditor should also identify the changes in the shareholding that might have taken place since the last audit.

21. It is also important to note that ownership of voting power is not necessary for an entity to own more than one-half of the voting power of another to control the other enterprise. Control of the composition of the Board of Directors (in the case of a company) or corresponding governing body (in the case of any other enterprise), with a view to obtain economic benefits from its activities, ownership of voting power is not important. For example, an entity holds only 10 percent of the share capital of another entity but it has control over the composition of the Board of Directors/governing body of the second entity. In such a case, the first entity would be considered as a parent of the second entity and, therefore, it would consolidate the second entity in the consolidated financial statements as subsidiary. The auditor, therefore, apart from carrying out above procedures, should verify whether the parent controls the composition of the Board of Directors or corresponding governing body of any entity. There would be various means by which such kind of control can be obtained. In this regard, the auditor may verify the Board's minutes, shareholder agreements entered into by the parent, agreements with the entities to which the parent might have provided any technology or know how, enforcement of statute, as the case may be, etc. The auditor would have to use his professional judgement to determine whether the parent controls the composition of the Board of Directors of any other entity. If yes, whether that entity has been consolidated as a subsidiary in the consolidated financial statements.

22. Where a subsidiary or an associate or a jointly controlled entity is excluded from the consolidated financial statements, the auditor should examine the reasons for exclusion. There could be two reasons for exclusion of a subsidiary, associate or jointly controlled entity – one, that the relationship of parent with the subsidiary, associate or jointly controlled entity is intended to be temporary or the subsidiary, associate or joint venture operates under several long-term restrictions which significantly impair its ability to transfer funds to the parent. The auditor should satisfy himself that the exclusion made by the management falls within these two categories. The auditor should verify such long-term restrictions from the relevant laws and regulations, agreements entered by the parent with such entities which prohibit transfer of funds. In the case of an entity which is excluded from consolidation on the ground that the relationship of parent with the other entity as subsidiary, associate or joint venture is temporary, the auditor should verify that the intention of the parent, to dispose the subsidiary, investment in associate or interest in jointly controlled entity, in the near future, existed at the time of acquisition of the subsidiary, making investment in associate or jointly controlled entity. The auditor should also verify that the reasons for exclusion are given in the consolidated

financial statements. If an entity is excluded from the consolidated financial statements for reasons other than those allowed by the relevant accounting standards, the auditor should consider its effect on the report to be issued. The auditor should consider the need to issue a modified report on the consolidated financial statements. The auditor should also verify that in consolidated financial statements, investments in such subsidiaries, associates or jointly controlled entities should be accounted for in accordance with Accounting Standard (AS) 13, "Accounting for Investments".

23. The auditor should also examine whether any subsidiary, associate or jointly controlled entity has ceased to be a subsidiary, associate or jointly controlled entity during the period under audit. It is also possible that a subsidiary might have become an associate or an associate might have become a subsidiary of the parent. The auditor, in such cases, should examine whether these changes have been appropriately accounted for in the consolidated financial statements as required by the respective accounting standards.

24. In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, income and expenses and then certain calculations like determination of goodwill or capital reserve, minorities interest and adjustments like elimination of intra group transactions, balances and unrealised profits etc. are made in accordance with the requirements of Accounting Standard (AS) 21, "Consolidated Financial Statements". Investments in associates are accounted for using the Equity Method as prescribed in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements". A parent that has an interest in a jointly controlled entity, reports its interest in the consolidated financial statements using proportionate consolidation method in accordance with Accounting Standard (AS) 27, "Financial Reporting of Interests in Joint Ventures". Many of the procedures appropriate for the application of equity method and the proportionate consolidation are similar to the consolidation procedures set out in Accounting Standard (AS) 21, "Consolidated Financial Statements".

25. The auditor should verify that the adjustments warranted by the relevant accounting standards have been made wherever required and have been properly authorised by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation adjustments.

#### **Special Considerations**

##### **Permanent Consolidation Adjustments<sup>3</sup>**

26. Permanent consolidation adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. Permanent consolidation adjustments are:

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<sup>3</sup> Reference may be made to Appendix I 'Consolidated Balance Sheet of Group' for an understanding of permanent consolidation adjustments.

- (a) determination of excess or deficit of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made (determination of goodwill or capital reserve);
- (b) determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made; and
- (c) determination of goodwill or capital reserve arising on application of equity method to account for investments in associates in consolidated financial statements.

27. The auditor should verify that the above calculations have been made appropriately. The auditor should pay particular attention to the determination of pre-acquisition reserves of the subsidiary and associates. Date(s) of investment in subsidiary and associates assumes importance in this regard. The auditor should also examine whether the pre-acquisition reserves have been allocated appropriately between the parent and the minorities of the subsidiary. The auditor should also verify the changes that might have taken place in these permanent adjustments on account of subsequent acquisition of shares in the subsidiary/associates, disposal of the subsidiary/associate in the subsequent years. The auditor should also examine the joint venture agreements, to establish whether any change has taken place in the interest of the parent in the joint venture.

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

#### **Current Period Consolidation Adjustments<sup>4</sup>**

29. Current period adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done. Current period consolidation adjustments primarily relate to elimination of intra-group transactions and account balances including:

- (a) intra-group interest paid and received, or management fees, etc;
- (b) unrealised intra-group profits on assets acquired from other subsidiaries;
- (c) intra-group indebtedness;
- (d) adjustments related to harmonising the different accounting policies being followed by the parent enterprise and its subsidiaries;
- (e) adjustments made for the effects of significant transactions or other events that occur between the date of the financial statements of the parent and one or more of the components, if the financial statements to be used for consolidation are not drawn upto the same reporting date; and

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<sup>4</sup> Reference may be made to Appendix I and II for current period consolidation adjustments.

### III.200 Auditing Pronouncements

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- (f) determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.

30. The adjustments required for preparation of consolidated financial statements are made in memorandum records kept for the purpose by the parent. The auditor should review the memorandum records to verify the adjustment entries made in the preparation of consolidated financial statements. This would also help the auditor in ascertaining whether there is any difference in the elimination. Apart from reviewing the memorandum records, the auditor should:

- (a) verify that the inter-group transactions and account balances have been eliminated;
- (b) verify that the consolidated financial statements have been prepared using uniform accounting policies for like transactions and other events in similar circumstances;
- (c) verify that adequate disclosures have been made in the consolidated financial statements of application of different accounting policies in case, it was impracticable to do so;
- (d) verify the adjustments made to harmonise the different accounting policies; and
- (e) verify that the calculation of minorities interest has been correctly done.

31. The auditor should gain an understanding of the procedures adopted by the management of the enterprise to make the above mentioned adjustments. This helps the auditor in reducing the audit risk to an acceptably low level.

32. One of the important adjustment that may be required in the current period is determination of impairment loss that might exist for goodwill arising on consolidation. Goodwill arising on consolidation is carried at the value determined at the date of acquisition of the subsidiary, and the same is to be tested for impairment at every balance sheet date. The auditor should examine whether any impairment loss has been determined by the parent. If yes, the auditor should examine the procedure followed for determination of impairment. The auditor should satisfy himself that the amount of impairment loss determined is fair.

33. The auditor should also verify that the disclosures required by Accounting Standard (AS) 21, "Consolidated Financial Statements", Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements" and Accounting Standard (AS) 27, "Financial Reporting of Interests in Joint Ventures" have been made in the consolidated financial statements.

34. Apart from verifying that the calculation and disclosures regarding minorities interest have been made appropriately, the auditor also determines, in cases where the minority interests' share of the losses exceed the minority interests' share of the equity, the excess, and any further losses applicable to the minority interest, have been accounted for in accordance with the relevant accounting standards. Where the minority interest has a binding obligation to make good losses, the auditor of the consolidated financial statements determines whether it is able to do so.

35. If the financial statements of one or more of the components are drawn upto different financial reporting dates, the auditor of the consolidated financial statements should review

the component's results between its financial reporting date and that of the parent for significant transactions or other events that have taken place during the period and therefore, need to be reflected in the consolidated financial statements. For example, where a subsidiary has a different accounting period and after the end of its accounting period, the subsidiary has discontinued its one of the major operations, adjustments would be required to be made to reflect this in the consolidated financial statements.

36. The fundamental accounting assumption of "consistency" requires the auditor of the consolidated financial statements to consider whether the length of the reporting periods and any difference in financial year-ends are the same from period to period.

37. Notes to accounts and other explanatory material are an integral part of any financial statements since they provide information which is *per se* not reflected in the balance sheet and profit and loss account. Consolidated financial statements are not an exception to the need of notes to accounts and other explanatory material. In this regard paragraph 6 of Accounting Standard (AS) 21, "Consolidated Financial Statement" states as below:

"6. Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, other statements and explanatory material that form an integral part thereof. Consolidated cash flow statement is presented in case a parent presents its own cash flow statement. The consolidated financial statements are presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements".

38. The Accounting Standards Board of the Institute has issued General Clarification (GC)-5/2002 on Notes to the Consolidated Financial Statements. The Clarification lays down certain principles that should be observed in respect of notes and other explanatory material that form integral part of the consolidated financial statements. The auditor should verify that the principles enunciated by the Clarification have been followed in preparation of notes to accounts. The auditor to verify, the compliance, should:

- (a) examine that the notes which are necessary for presenting a true and fair view of the consolidated financial statements have been included in the consolidated financial statements as an integral part thereof; and
- (b) examine that additional statutory information disclosed in separate financial statements of the subsidiary and/or a parent having bearing on the true and fair view of the consolidated financial statements have been disclosed in the consolidated financial statements.

39. If as a result of the above examinations, the auditor is of the view that the consolidated financial statements do not disclose all the information which is necessary for presenting a true and fair view, the auditor should give a modified report.

#### **Management Representations**

40. Standard on Auditing (SA) 580, "Representations by Management" requires the auditor to obtain appropriate representations from management. The auditor of the consolidated financial statements should obtain evidence that the management of the parent acknowledges

### III.202 Auditing Pronouncements

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its responsibility for a true and fair presentation of the consolidated financial statements in accordance with the financial reporting framework applicable to the parent and that parent management has approved the consolidated financial statements. In addition, the auditor of the consolidated financial statements obtains written representations from parent management on matters material to the consolidated financial statements. Examples of such representations include:

- (a) Completeness of components included in the consolidated financial statements;
- (b) Identification of reportable segments for segmental reporting;
- (c) Identification of related parties and related party transactions for reporting;
- (d) Appropriateness and completeness of consolidation adjustments, including the elimination of intra-group transactions.

#### **Reporting\*\***

41. There could be two situations in an audit of consolidated financial statements--when the parent's auditor is also the auditor of all the components to be included in the consolidated financial statements and when the parent's auditor is not the auditor of one or more subsidiaries and therefore, uses the work of other auditors in the audit. The auditor should, while preparing the report, should consider the requirements of Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements". Where, the auditor uses the work of other auditors in the audit of consolidated financial statements, the requirements of Standard on Auditing (SA) 600, "Using the Work of Another Auditor" should also be considered.

#### **When the Parent's Auditor is also the Auditor of its Subsidiaries**

42. While drafting the audit report, the auditor should report whether principles and procedures for preparation and presentation of consolidated financial statements as laid down in the relevant accounting standards have been followed. In case of any deviation, the auditor should make adequate disclosure in the audit report so that users of the consolidated financial statements are aware of such deviation.

43. Auditor should issue an audit report expressing opinion whether the consolidated financial statements give a true and fair view of the state of affairs of the Group as on balance sheet date and as to whether consolidated profit and loss statement gives true and fair view of the results of consolidated profit or losses of the Group for the period under audit. Where the consolidated financial statements also include a cash flow statement, the auditor should also give his opinion on the true and fair view of the cash flows presented by the consolidated cash flow statements. Suggested format of the audit report to be issued in such circumstance is given as **Annexure I** to this Guidance Note.

#### **When the Parent's Auditor is not the Auditor of its Subsidiary(ies)**

44. In a case where the parent's auditor is not the auditor of the components included in the consolidated financial statements, the auditor of the consolidated financial statements should also consider the requirement of SA 600.

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\*\* With the issuance of this Guidance Note, the format of report on Consolidated Financial Statements issued in March, 2001 shall stand withdrawn.

45. When the parent's auditor decides that he will make reference to the audit of the other auditors, the auditor's report on consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s). This may be done by stating the rupee amounts or percentages of total assets and total revenue of subsidiary(s) included in consolidated financial statements not audited by the parent's auditor. However, reference in the report of the auditor of consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries. Suggested format of the audit report to be issued by the auditor of consolidated financial statements in this circumstance is given in **Annexure II** to this Guidance Note.

### Annexure I

#### Illustrative Auditor's Report on the Consolidated Financial Statements When the Parent's Auditor is also the Auditor of all the Components

##### Auditor's Report

The Board of Directors  
 \_\_\_\_\_ (Name of the Parent)<sup>5</sup>

We have audited the attached consolidated balance sheet of XYZ Group, as at 31st March 2XXX, and also the consolidated profit and loss account and the {consolidated cash flow statement}<sup>6</sup> for the year ended on that date annexed thereto. These financial statements are the responsibility of the XYZ's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

We report that the consolidated financial statements have been prepared by the XYZ's management in accordance with the requirements of Accounting Standards (AS) 21, "Consolidated Financial Statements", {Accounting Standards (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements" and Accounting Standard (AS) 27, "Financial Reporting of interests in Joint Ventures"}<sup>7</sup> issued by the Institute of Chartered Accountants of India.

<sup>5</sup> As per paragraph 8 of SA 700, "The Auditor's Report on Financial Statements", "The auditor's report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations. Ordinarily, the auditor's report is addressed to the authority appointing the auditor".

<sup>6</sup> Where applicable.

<sup>7</sup> *ibid.*

### III.204 Auditing Pronouncements

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In our opinion and to the best of our information and according to the explanations given to us, the consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the consolidated balance sheet, of the state of affairs of the XYZ Group as at 31<sup>st</sup> March 2XXX;
- (b) in the case of the consolidated profit and loss account, of the profit / loss<sup>8</sup> for the year ended on that date; and
- (c) in the case of the consolidated cash flow statement, of the cash flows for the year ended on that date. .

For ABC and Co.  
Chartered Accountants

Signature  
(Name of the Member Signing the Audit Report)  
(Designation<sup>9</sup>)  
Membership Number

Place of Signature

Date

#### Annexure II

#### Illustrative Auditor's Report on the Consolidated Financial Statements When the Parent's Auditor is Not the Auditor of All the Components

##### Auditor's Report

The Board of Directors  
\_\_\_\_\_ (Name of the Parent)<sup>10</sup>

We have audited the attached consolidated balance sheet of XYZ Group, as at 31<sup>st</sup> March 2XXX, and also the consolidated profit and loss account and the {consolidated cash flow statement}<sup>11</sup> for the year ended on that date annexed thereto. These financial statements are the responsibility of the XYZ's management and have been prepared by the management on the basis of separate financial statements and other financial information regarding components. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance

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<sup>8</sup> *ibid.*

<sup>9</sup> Partner or proprietor, as the case may be.

<sup>10</sup> See Footnote 5.

<sup>11</sup> Where applicable.

about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We did not audit the financial statements of certain subsidiaries, whose financial statements reflect total assets of Rs. \_\_\_\_\_ as at 31st March 2XXX, the total revenue of Rs. \_\_\_\_\_ and cash flows amounting to Rs. \_\_\_\_\_ for the year then ended. These financial statements and other financial information have been audited by other auditors whose report(s) has (have) been furnished to us, and our opinion is based solely on the report of other auditors.

We report that the consolidated financial statements have been prepared by the XYZ's management in accordance with the requirements of Accounting Standards (AS) 21, "Consolidated Financial Statements", {Accounting Standards (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements" and Accounting Standard (AS) 27, "Financial Reporting of interests in Joint Ventures"}<sup>12</sup> issued by the Institute of Chartered Accountants of India.

Based on our audit and on consideration of reports of other auditors on separate financial statements and on the other financial information of the components, and to the best of our information and according to the explanations given to us, we are of the opinion that the attached consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the consolidated balance sheet, of the state of affairs of the XYZ Group as at 31<sup>st</sup> March 2XXX;
- (b) in the case of the consolidated profit and loss account, of the profit / loss<sup>13</sup> for the year ended on that date; and
- (c) in the case of the consolidated cash flow statement, of the cash flows for the year ended on that date. .

For ABC and Co.  
Chartered Accountants

Signature  
(Name of the Member Signing the Audit Report)  
(Designation<sup>14</sup>)  
Membership Number

Place of Signature:

Date:

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<sup>12</sup> *ibid.*

<sup>13</sup> *ibid.*

<sup>14</sup> Partner or proprietor, as the case may be.

**Consolidated Balance Sheet of a Group**

*The appendix is illustrative only and does not form part of the Guidance Note. The purpose of this appendix is to illustrate the application of Accounting Standard (AS) 21, Consolidated Financial Statements.*

1. The example shows only current period amounts.
2. The amounts given in the brackets indicate deductions.
3. The working notes given towards the end of this appendix are intended to assist in understanding the manner in which the various figures appearing in the consolidated balance sheet have been derived. These working notes do not form part of the consolidated balance sheet and, accordingly, need not be published.
4. The following are the balance sheets as at 31<sup>st</sup> March, 2003 of X Limited (the holding company), Y Limited and Z Limited (both subsidiaries of X Limited)

(Rs.'000)

Sources of Funds	X Limited	Y Limited	Z Limited
Share Capital	4,500.00	1,000.00	2,000.00
Reserves and Surplus	150.00	195.00	390.00
6% Debentures	-	250.00	-
Current Liabilities	420.00	210.00	300.00
<b>Total</b>	<b>5,070.00</b>	<b>1,655.00</b>	<b>2,690.00</b>

Application of Funds	X Limited	Y Limited	Z Limited
Fixed Assets	1,600.00	490.00	1,400.00
Investments in Subsidiaries	2,560.00	-	-
Inventories	520.00	650.00	850.00
Cash	200.00	230.00	160.00
Other Current Assets	190.00	285.00	280.00
<b>Total</b>	<b>5,070.00</b>	<b>1,655.00</b>	<b>2,690.00</b>

5. The following additional information is also relevant for the preparation of the consolidated balance sheet:
  - (i) The break-up of investments of X Limited is as follows:

	<i>Carrying Cost</i>
(a) 80,000 equity shares of Rs.10 each of Y Limited	880.00
(b) 1,35,000 equity shares of Rs.10 each of Z Limited	1,200.00
(c) 4,000 preference shares of Rs.100 each of Z Limited	400.00
(d) 800 6% Debentures of Rs.100 each of Y Limited	80.00
<b>Total</b>	<b>2,560.00</b>

6. All the above investments were made on 30th September, 1998. The summarised balance sheets of Y Limited and Z Limited as on that date were as follows:

	(Rs.'000)	
<b>Sources of Funds</b>	<b>Y Limited</b>	<b>Z Limited</b>
Share Capital	1,000.00	2,000.00
Reserves and Surplus	152.50	305.00
6% Debentures	250.00	-
Current Liabilities	300.00	400.00
<b>Total</b>	<b>1,702.50</b>	<b>2,705.00</b>
 <b>Application of funds</b>		
Fixed Assets	500.00	1,450.00
Current Assets	1,202.50	1,255.00
<b>Total</b>	<b>1,702.50</b>	<b>2,705.00</b>

7. The Share Capital of Subsidiary consisted of

	<b>Y Limited</b>	<b>Z Limited</b>
Equity Shares of Rs.10/- each	1,000.00	1,500.00
Pref. Shares of Rs.100/- each	Nil	500.00
<b>Total</b>	<b>1,000.00</b>	<b>2,000.00</b>

8. Current assets of Y Limited includes bills receivables for Rs.8,000 accepted by X Limited.  
 9. Current Liabilities of Z Limited include Rs.2,000 due to X Limited.  
 10. Stock of X Limited include goods of Rs.10,000 purchased from Y Limited on which the latter company made a profit of Rs.2,000.

Consolidated Balance Sheet of X Limited and its Subsidiaries Y Limited and Z Limited  
as at 31<sup>st</sup> March 2003.

(Rs. '000)					
Sources of Funds	X Limited	Y Limited	Z Limited	Elimination Entries	Consolidated Amounts
Share Capital	4,500.00	1,000.00	2,000.00	(3,000.00) <sup>1</sup>	4,500.00
Reserves and Surplus	150.00	195.00	390.00	(476.50) <sup>2</sup>	258.50
Capital Reserve (Negative Goodwill)	--	--	--	466.50 <sup>3</sup>	466.50
6% Debentures	--	250.00	--	(80.00) <sup>4</sup>	170.00
Current Liabilities	420.00	210.00	300.00	(28.00) <sup>5</sup>	902.00
Minorities Interest	--	--	--	528.00 <sup>6</sup>	528.00
<b>Total</b>	<b>5070.00</b>	<b>1655.00</b>	<b>2690.00</b>	<b>(2590.00)</b>	<b>6,825.00</b>
Application of Funds	X Limited	Y Limited	Z Limited	Elimination Entries	Consolidated Amounts
Fixed Assets	1,600.00	490.00	1,400.00	-	3,490.00
Investments	2,560.00	-	-	(2,560.00)	NIL
Cash	200.00	230.00	160.00	-	590.00
Inventories	520.00	650.00	850.00	(2.00) <sup>7</sup>	2,018.00
Other Current Assets	190.00	285.00	280.00	(28.00) <sup>5</sup>	727.00
<b>Total</b>	<b>5070.00</b>	<b>1655.00</b>	<b>2690.00</b>	<b>(2590.00)</b>	<b>6,825.00</b>

### Working Notes

#### 1. Elimination of share capital of subsidiaries@:

	Y Limited	Z Limited	Total
<b>Equity Share Capital</b>			
(i) Used in elimination of carrying cost of investment in each subsidiary	800.00	1,350.00	2,150.00
(ii) Included in the Minorities Interest	200.00	150.00	350.00
<b>Preference Share Capital</b>			
(i) Held within the Group (held by holding company)	Nil	400.00	400.00
(ii) Included in the Minorities Interest	Nil	100.00	100.00
<b>Total share capital eliminated</b>	<b>1,000.00</b>	<b>2,000.00</b>	<b>3,000.00</b>

#### 2. Break-up of reserves and surplus eliminated:

	Y Limited	Z Limited	Total
<b>(i) Reserves up to the date of investment@@:</b>			
a) Attributable to the holding company (utilised in eliminating carrying cost of investment)	122.00	274.50	396.50
b) Attributable to Minorities (included in minorities interest)	30.50	30.50	61.00
<b>(i) Movement in reserves and surplus after the date of investment@@@:</b>			
a) Attributable to Minorities (included in minorities interest)	8.50	8.50	17.00
(ii) Profit earned by the subsidiary Y Limited on account of sale of goods to X Limited.	2.00	--	2.00
<b>Total reserves and surplus eliminated</b>	<b>163.00</b>	<b>313.50</b>	<b>476.50</b>

@ Permanent consolidation adjustments.

@@ *ibid.*

@@@ Current period consolidation adjustments.

### III.210 Auditing Pronouncements

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3. Elimination of carrying cost of investments in equity shares of each subsidiary:

	Y Limited	Z Limited
Carrying Cost	880.00	1,200.00
<i>Less:</i> Equity attributable to the holding company at the date at which investment was made (see working note 8 below)	(922.00)	(1,624.50)
<b>Negative Goodwill (capital reserve)</b>	<b>(42.00)</b>	<b>(424.50)</b>

4. The elimination of investment in Y Limited's 6% Debentures needs explanation. The holding company acquired debentures at face value of Rs.80,000. The consolidated amounts should represent debentures of the subsidiary Y Limited outside the group.
5. Bills payable of Rs.8,000 and debtors of Rs.20,000 are inter company owings and therefore eliminated.
6. Computation of Minorities Interest

	Y Limited	Z Limited	Total
(a) Amount of equity attributable to minorities at the date at which investment in each subsidiary is made (as computed in working note 8 below)	230.50	180.50	411.00
(b) Minorities' share in movement in equity since the date of investment in each subsidiary (as computed in working note 9 below)	8.50	8.50	17.00
(c) Amount of Preference Share Capital held outside the Group	Nil	100.00	100.00
<b>Total</b>	<b>239.00</b>	<b>289.00</b>	<b>528.00</b>

7. The profit earned by Y Limited is reduced from the consolidated amount of inventories so that it can be valued at cost to the group as a whole.
8. Equity of the subsidiary companies Y Limited and Z Limited at the date at which investment is made:

	Y Limited	Z Limited
Fixed Assets	500.00	1,450.00
Current Assets	1,202.50	1,255.00
Debentures	(250.00)	--

Current Liabilities	(300.00)	(400.00)
Preference Share Capital	--	(500.00)
<b>Equity on the date of investment</b>	<b>1,152.50</b>	<b>1805.00</b>
<i>Equity attributable to the holding company</i> (see working note 10 below)	922.00	1,624.50
<i>Equity attributable to the minorities</i> (see working note 10 below)	230.50	180.50
<b>Total</b>	<b>1,152.50</b>	<b>1,805.00</b>

## 9. Movement in equity of subsidiaries since the date of investment in each subsidiary:

	Y Limited	Z Limited
Equity as on 31 <sup>st</sup> March, 1999	1,195.00	1,890.00
<i>Less: Equity on the date of Investment (as computed in working note 8 above)</i>	(1,152.50)	(1,805.00)
<b>Movement in equity</b>	<b>42.50</b>	<b>85.00</b>
<i>Movement in Equity attributable to the holding company (see working note 10 below)</i>	34.00	76.50
<i>Movement in Equity attributable to the minorities (see working note 10 below)</i>	8.50	8.50
	<b>42.50</b>	<b>85.00</b>

## 10. Compilation of extent of holding of X Limited and minority interest:

	Y Limited	Z Limited
Total equity shares	1,00,000	1,50,000
No. of equity shares with X Limited	80,000	1,35,000
Extent of holding of X Limited	80%	90%
Minority Interest	20%	10%

## Consolidated Profit and Loss Statement

*The appendix is illustrative only and does not form part of the Guidance Note. The purpose of this appendix is to illustrate the application of the Accounting Standard, (AS) 21, Consolidated Financial Statements.*

1. The example shows only current period amounts.
2. The following additional information is also relevant for the preparation of the consolidated profit and loss statement (figures are in Rs.'000):
  - (a) The holding company A Limited purchased 2,70,000 equity shares of Rs.10 each (75% of the total equity share capital) and 9,000 9% preference shares of Rs.100 each (50% of the total preference share capital) of the subsidiary company B Limited on 1st November, 1998.
  - (b) A Limited proposes to pay a final dividend on equity shares @ 25%. A Limited paid an interim dividend of Rs.1,350 during the financial year 2002-2003.
  - (c) B Limited proposes to pay a final dividend on equity shares @ 20%. B Limited paid an interim dividend of Rs.720 on 1st October 2002. An interim dividend of Rs.81 was paid on preference shares also. The holding company did not participate in the interim dividend.
  - (d) B Limited sold to A Limited in March, 1999 material for Rs.750 at cost plus 25% of which A Limited still had unsold stock of Rs.500 as on 31st March, 2003.

**Consolidated Profit and Loss Statement of A Limited and its Subsidiary B Limited for the year ended 31st March, 2003**

	(Rs.'000)			
Income	A Limited	B Limited	Elimination Entries	Consolidated Amounts
Sales	16,200.00	15,300.00	(750.00) <sup>1</sup>	30,750.00
Proposed Dividend from B Limited	540.00	-	(540.00) <sup>2</sup>	NIL
Dividend on Preference Shares of B Ltd.	40.50	-	(40.5) <sup>2</sup>	NIL
<b>Total Income (A)</b>	<b>16,780.50</b>	<b>15,300.00</b>	<b>(1,330.50)</b>	<b>30,750.00</b>
Expenditure	A Limited	B Limited	Elimination Entries	Consolidated Amount
Consumption of raw materials	8,280.00	8,820.00	(750.00) <sup>1</sup>	16,350.00

Overhead Expenses	2,070.00	945.00	-	3,015.00
Selling Expenses	810.00	1,215.00	-	2,025.00
Provision for Tax	2,700.00	1,944.00	-	4,644.00
Total Expenditure (B)	13,860.00	12,924.00	(750.00)	26,034.00
<b>Net Profit for the year (A-B)</b>	<b>2,920.50</b>	<b>2,376.00</b>	<b>(580.50)</b>	<b>4,716.00</b>

**Consolidated Profit and Loss Appropriation Account of A Limited and its Subsidiary B Limited for the year ended 31st March, 2003**

	A Limited	B Limited	Elimination Entries	Consolidated Amounts
Opening Balance	481.50	576.00	-	1,057.50
Add: Net Profit for the year	2,920.50	2,376.00	(580.50)	4,716.00
Less: Preference Dividend for the year		(162.00)	40.50 <sup>2</sup>	(121.50)
Less: Equity Dividend for the year	(2,700.00)	(1,440.00)	540.00 <sup>2</sup>	(3,600.00)
<b>Balance to be adjusted for consolidation</b>	<b>702.00</b>	<b>1,350.00</b>	<b>000.00</b>	<b>2,052.00</b>
Amount credited to Investment Account	321.75 <sup>3</sup>	-	-	321.75
Amount utilised in elimination of the Cost of Investment in Subsidiary	-	-	545.62 <sup>4</sup>	545.62
Balance attributable to minorities	-	-	337.50 <sup>5</sup>	337.50
Unrealised Profit on Stock (stock reserve)			100.00 <sup>6</sup>	100.00
Amounts transferred to consolidated Balance Sheet	380.25	1,350.00	(983.12)	747.13
<b>Total</b>	<b>702.00</b>	<b>1,350.00</b>	<b>000.00</b>	<b>2,052.00</b>

### Working Notes

*For the purpose of the working notes, it is assumed that profits accrued evenly throughout the financial year 2003-2003. Accordingly, the profits are apportioned as 'Profits upto the date of Investment' and 'Profits after the date of Investment' on the basis of months. An alternative treatment calls for preparation of Profit and Loss Statement and Balance Sheet of the subsidiary company on the date at which investment is made by the Holding Company.*

1. Since sales made by the subsidiary company B Limited to A Limited in March 2003 is an inter-company transaction, it is therefore, eliminated.

2. The holding company did not participate in the interim dividend declared by the subsidiary. The holding company is entitled to receive the final dividend as follows:

(a) Final dividend on equity shares [72 x 0.75]	Rs.540.00
(b) Final dividend on preference share [81 x 0.5]	Rs. 40.50

Since the above dividends are also inter-company transactions, therefore, eliminated.

3. Amount credited to Investment Account: The holding company A Limited credited to its Profit and Loss Statement the dividends received from the subsidiary B Limited. The dividends pertaining to pre-acquisition period represent recovery of cost and do not form part of income. Therefore, the same is required to be credited to the Investment Account.

Pre-acquisition period is for 7 months i.e., April 1998 to 1st November 1999

(a) Pre-acquisition equity dividend [Rs.540 x 7/12]	Rs. 31.50
(b) Pre-acquisition preference dividend [Rs.40.50 x 1/6]	Rs. 6.75

4. Holding company's share in the profit upto the date of investment in subsidiary forms part of equity on the date at which investment in subsidiary is made. Therefore, such profits are utilised in eliminating the cost of investments in subsidiary. Profits are computed as under:

(a) Opening Balance of the Profit and Loss Account	Rs. 576.00
(b) Net Profit earned during the period 1.4.98 to 1.11.98 i.e., 2376 x 7/12	Rs.1,386.00
(c) Interim dividend on equity shares	Rs. (720.00)
(d) Final dividend on equity shares for the period 2002-2003 (apportioned in the ratio of months 7:5) [720 x 7/12]	Rs. (420.00)
(e) Interim dividend on preference shares	Rs. (81.00)
(f) Final dividend on preference shares (it relates to the last six months of the financial year, therefore, apportioned in the ratio of 1:5) [Rs.81.00 x 1/6]	<u>Rs. (13.50)</u>

Total profits of the subsidiary upto the date of Investment	<u>Rs. 727.50</u>
Holding Company's share in the profits computed (0.75 x 727.5)	Rs. 545.62
5. Minorities have a share of 25% in the total profit of the subsidiary company. [Rs.1,350 x 0.25]	Rs. 337.50
6. Computation of Unrealised Profit on Stock	
(i) Value of unsold stock	Rs. 500.00
(ii) Profit included is 20% on cost Unrealised profit [Rs.500.00 x 0.20]	Rs. 100.00

## GUIDANCE NOTE ON CERTIFICATE ON CORPORATE GOVERNANCE (REVISED 2006)\*

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### 1. INTRODUCTION

1.1 Corporate Governance is the system by which companies are directed and governed by the management in the best interests of the stakeholders and others ensuring better management, greater transparency and timely financial reporting. The three key aspects of corporate governance includes *inter-alia*, accountability, transparency and equality of treatment for all stakeholders. Since the pivotal role in any system of corporate governance is performed by the Board of Directors, they are primarily accountable and responsible for governance of their companies.

1.2 A number of reports and codes of Corporate Governance have already been published internationally – notable among them are the Report of Cadbury Committee, the Report of Greenbury Committee, the Combined Code of the London Stock Exchange, the OECD Code on Corporate Governance, the Blue Ribbon Committee on Corporate Governance, the Hampel Committee on Corporate Governance and the Review of the Role and Effectiveness of Non-executive Directors published by the Department of Trade and Industry, U.K.

1.3 Similarly in the Indian scenario, the Confederation of Indian Industry (CII) had published in April, 1988, Desirable Corporate Governance – A Code, which was followed by setting up of a committee by The Securities and Exchange Board of India (hereinafter referred to as "SEBI") in May, 1999 under the Chairmanship of Shri Kumar Mangalam Birla to formulate the code of Corporate Governance. Based on the report of this committee and developments thereafter, SEBI has issued seven Circulars<sup>1</sup> on the subject of Corporate Governance *inter-alia* detailing provisions of Corporate Governance.

1.4 Besides, the Reserve Bank of India constituted an Advisory Group on Corporate Governance, which submitted its report in April 2001. Thereafter, the then Ministry of Finance and Company Affairs constituted a Committee on Corporate Audit and Governance under the Chairmanship of Shri. Naresh Chandra, which submitted its report in November, 2002. Currently the Ministry of Company Affairs is considering further reforms in the arena of Corporate Governance through the Expert Committee on Simplification of New Company Law i.e., Dr J. J. Irani Committee.

Further, in its constant endeavor to improve the framework of Corporate Governance in India in line with needs of a dynamic market, SEBI constituted a Committee on Corporate

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\* Issued in January, 2006.

<sup>1</sup> List of earlier seven circulars given in Appendix A.

Governance under the Chairmanship of Shri N. R. Narayana Murthy, which submitted its report in February, 2003. Based on the recommendations of the said Committee and public comments received on the report, SEBI in exercise of powers conferred by section 11 (1) of the Securities and Exchange Board of India Act, 1992 read with section 10 of the Securities Contracts (Regulation) Act 1956, SEBI has revised the Clause 49 of the Listing Agreement as per Circular SEBI/CFD/DIL/CG/1/2004/12/10 dated 29th October, 2004<sup>2</sup>.

1.5 The SEBI Circular dated 29th October, 2004 is the Master Circular and has replaced all the earlier Circulars issued on Clause 49 of the Listing Agreement. Further through the issue of another Circular SEBI/CFD/DIL/CG/1/2005/29/3 dated 29th March, 2005<sup>3</sup> has extended the date of ensuring compliance with the revised Clause 49 (i.e. Circular dated 29th October, 2004) to December 31, 2005. Subsequently, SEBI vide Circular No. SEBI/CFD/DIL/CG/1/2006/13 dated 13th January, 2006<sup>4</sup> has made further clarificatory amendments and removed certain operational difficulties.

1.6 As per the SEBI Circular dt. October 29, 2004 the provisions of revised Clause 49 shall be implemented as per the schedule of implementation given below:

- (a) For entities seeking listing for the first time, at the time of seeking in-principle approval for such listing.
- (b) For existing listed entities which were required to comply with revised Clause 49 i.e. those having a paid up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company, by April 1, 2005.

Companies complying with the provisions of the existing Clause 49 at present (issued vide circulars dated 21st February, 2000, 9th March 2000, 12th September 2000, 22nd January, 2001 16th March 2001 and 31st December 2001) shall continue to do so till the revised Clause 49 of the Listing Agreement is complied with or till March 31, 2005 whichever is earlier. Subsequently, the date for ensuring compliance with the revised Clause 49 of the listing agreement was extended upto December, 31, 2005 and the revised Clause 49 of the listing agreement has come into effect from January 1, 2006.

1.7 The requirements of revised Clause 49 (hereinafter referred as Clause 49) for Corporate Governance are divided into mandatory<sup>5</sup> and non-mandatory requirements<sup>6</sup>. The non-compliance of any mandatory requirement of Clause 49 with reasons thereof should be specifically highlighted. The extent to which the non-mandatory requirements have been adopted / complied with should be mentioned in the Corporate Governance Report.

1.8 As Clause 49 VII (1) of the Listing Agreement, a company is required to obtain a certificate either from the auditors of the company or practicing company secretaries as regards compliance of requirements of Corporate Governance. This certificate is required to be annexed with the Directors' Report, which is sent annually to all the shareholders of the

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<sup>2</sup> Reproduced in Appendix D.

<sup>3</sup> Reproduced in Appendix E.

<sup>4</sup> Reproduced in Appendix F.

<sup>5</sup> See Annexure I.

<sup>6</sup> See Annexure ID.

### III.218 Auditing Pronouncements

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company. Further, the same certificate is also required to be sent to the stock exchange (s) along with the Annual Report filed by the company. The expression “auditors of the company” would mean the auditors appointed to audit the financial statements of the company under the Companies Act, 1956.

#### 2. OBJECTIVE OF THIS GUIDANCE NOTE

2.1 This Guidance Note is intended to provide guidance to auditors in certification of the compliance of requirements of Corporate Governance as stipulated in Clause 49 of the Listing Agreement between the Stock Exchange and the auditee company (hereinafter referred to as “Listing Agreement”):

2.2(a) It is the management’s responsibility to ensure implementation of requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement.

(b) The Auditor’s responsibility is to certify compliance of requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement.

(c) The Auditor obtains sufficient understanding of implementation of requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement.

2.3 This Guidance Note is intended to:

- assist in clarifying the respective responsibilities of the management and the auditor
- suggest inquiries the auditor is required to make from the management
- provide guidance on the verification procedure for the compliance of requirements of corporate governance
- assist in issuance of a certificate as required
- outline certain circumstances where the auditor may issue a disclaimer or adverse or qualified certificate.

#### 3. GENERAL APPROACH

For issuance of Certificate on Compliance of requirements of Corporate Governance as stipulated in Clause 49 of the Listing Agreement, the following general approach may be kept in mind:

3.1 As per SEBI circular dated 13th March, 2006 the revised Clause 49 of the listing agreement has come into effect from January, 1st, 2006. Therefore, for the reporting period as on 31st March, 2006, the auditor has to ensure that for the transition period, reporting requirements have to be split into two parts i.e., one for the period ending 31st December, 2005, for which the compliance of requirements would be as per requirements prior to the revised clause and for the period beginning from 1st January, 2006 to 31st March, 2006, the certificate would be for compliance of requirements as stipulated in the SEBI circular dated 29th October, 2004. The SEBI Circular No SEBI/CFD/DIL/ CG/1/2006/13/1 dated 13th January, 2006 has reiterated this position.

3.2 While determining the optimum combination of Executive and Non-executive Directors, it may be kept in mind that since the terms 'executive' and 'non-executive' have not been defined in Clause 49, auditor has to refer to the minutes of the Board.

3.3 While determining the number of independent and non-independent directors in the Board of Directors, the auditor should keep in mind the different limits that have been prescribed in Clause 49 (1A) (i) and (ii). The said clause provides that where the Chairman of the Board is a Non-executive director, at least one-third of the Board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors.

3.4 The above clause provides for two sets of limit for the composition of independent directors in the Board where the Chairman is a Non-executive director and where the Chairman is an Executive Director.

3.5 In arriving at the number of independent directors in either of the cases as mentioned above, any fraction thereof should be rounded off to the next integer as the words used in the clause is "not less than" and "at least".

3.6 While planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that non-compliance by the company with laws and regulations may materially affect the financial statements. Also it should be noted that as per SA 250, (Consideration of Laws and Regulations in an Audit of Financial Statements), compliance with Laws and Regulations is the responsibility of the management.

3.7 For the purpose of verification of compliance of requirements of Corporate Governance, the auditor would be required to review the policies prescribed, the process and procedures followed and the documentation in this regard.

3.8 While issuing the certificate on compliance of requirements of Corporate Governance as stipulated in Clause 49, the auditor has to observe the timing and the procedure which are generally followed in regard to obtaining the financial statements as approved by the Board, draft Directors' Report, draft report on corporate governance<sup>7</sup> and issuance of auditor's report.

#### 4. MANAGEMENT'S RESPONSIBILITY

Managements' responsibility for conducting its business implicitly requires it to take reasonable steps to ensure the implementation of the requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement. Under the terms of the Listing Agreement, a company is statutorily bound to implement the requirements of Clause 49 of the Listing Agreement. This flows from provision of Section 21 of the Securities Contracts (Regulation) Act, 1956. Section 23 of SCRA, 1956 provides for stringent penalties<sup>8</sup> for non-compliance of Section 21 of the said Act.

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<sup>7</sup> See Annexure – IB.

<sup>8</sup> Presently, the non-compliance with the conditions of the listing agreement attract a penalty, punishable with imprisonment for a term which may extend to ten years or with fine, which may extend to twenty-five crore rupees, or with both.

## 5. AUDITOR'S RESPONSIBILITY

5.1 The Auditor's responsibility in certifying compliance of requirements of corporate governance relate to verification and certification of factual implementation of requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement. Such verification and certification is neither an audit nor an expression of opinion on financial statements of the company.

5.2 The certificate from the Auditor as regards compliance of requirements of corporate governance is neither an assurance as to the future viability of the company nor the efficiency or effectiveness with which the management has conducted the affairs of the company.

## 6. GENERAL PRINCIPLES

6.1 The Standards set out in Standards on Auditing would be applicable in performance of certification of requirements of corporate governance by the Auditor, to the extent relevant.

6.2 As in the case of other professional assignments, in certification of compliance of requirements of corporate governance, the Auditor should comply with the "Code of Ethics" issued by the Institute of Chartered Accountants of India.

6.3 The Auditor should conduct verification of compliance of requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement in accordance with this Guidance Note.

## 7. DOCUMENTATION

The auditor should document matters, which are important in providing evidence to support the certificate of factual findings in accordance with SA 230, "Documentation".

## 8. VERIFICATION OF COMPLIANCE OF CONDITIONS OF CORPORATE GOVERNANCE

8.1 The verification of compliance of requirements conditions of Corporate Governance is discussed hereunder with reference to various paragraphs of Clause 49 of the Listing Agreement. The relevant paragraphs are reproduced followed by the verification procedure.

### 8.2 Board of Directors

#### 1. (A) *Composition of Board*

- (i) *The Board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors.*
- (ii) *Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors.*
- (iii) *For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who:*

- (a) *apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;*
- (b) *is not related to promoters or persons occupying management positions at the board level or at one level below the board;*
- (c) *has not been an executive of the company in the immediately preceding three financial years;*
- (d) *is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:*
  - (i) *the statutory audit firm or the internal audit firm that is associated with the company, and*
  - (ii) *the legal firm(s) and consulting firm(s) that have a material association with the company.*
- (e) *is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director, and*
- (f) *is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.*

**Explanation:** *For the purposes of the sub-clause (iii):*

- (a) *Associate shall mean a company which is an "associate" as defined in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements", issued by the Institute of Chartered Accountants of India.*
- (b) *"Senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.*
- (c) *"Relative" shall mean "relative" as defined in section 2(41) and section 6 read with Schedule IA of the Companies Act, 1956.*
- (iv) *Nominee directors appointed by an institution, which has invested in or lent to the company shall be deemed to be independent directors.*

**Explanation:** *"Institution" for this purpose means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a "corresponding new bank" as defined in section 2(d) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts]."*

**[Clause 49 I (A)]**

### III.222 Auditing Pronouncements

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8.3 The auditor should ascertain throughout the reporting period whether the Board of Directors comprises not less than 50% of the directors who are non-executive directors. The expressions "executive directors" and "non-executive directors" have not been explained in Clause 49. The non-executive directors are directors who are not involved in day-to-day management of the company. However, the expression "independent director" has been explained in the Clause 49 I (A) (iii) of the Listing Agreement. The minutes of the Board in this regard should be verified by the auditor for ascertaining as to which director is an independent director. It may further be noted that nominee directors appointed by an institution<sup>9</sup>, which has invested in or lent to the company shall be deemed to be independent directors. For the purpose of applying the test of "independence" of a director, reference may be made to Clause 49 I (A) (iii). It may, however, be noted that in the ultimate analysis, apart from the above referred objective tests, judgment based on facts of the case may also be kept in mind. A non-executive director may or may not be independent. However, an executive director cannot be considered as an independent director. Also such independent director should not be related to promoters or persons occupying management positions at the Board level or at one level below the Board. The minutes of the Board of Directors' should be verified to ascertain whether a director is an executive director or a non-executive director.

8.4 The auditor should also verify that where the Chairman of the Board is a non-executive director, at least 1 / 3rd of the Board should comprise of independent directors. In case the Chairman is an executive director, at least half of the Board should comprise of independent directors. In determining the number of requisite independent directors and / or non-executive directors, the fraction, if any, in number of one-half or one-third as the case may be should be rounded off. Since the terms in this clause refer to 'not less than' and 'at least', it would be appropriate to compute the number by rounding off any fraction to the next integer. For example, in a Board headed by non-executive Chairman and comprising of six other directors (i.e., seven directors) the independent directors should be three or more.

8.5 Annual Declaration by directors to the Board of Directors may be examined for this purpose. If Board of Directors has followed any particular procedure(s) to ascertain independence of directors, the Auditor should examine the same. Effect of changes in the composition of the Board and / or its Chairman and its impact on compliance throughout the reporting period may also be looked into.

8.6 It may be noted that a independent non-executive director apart from receiving remuneration should not have any material pecuniary relationship or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director.

8.6.1 Since the meaning of the term 'associate' is not apparent from Clause 49, a reference may be made to AS 23 (Accounting for Investments in Associates in Consolidated Financial Statements) which defines an associate as an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. However, for the purpose of sub-clause (iii) only an associate, which is a company should be considered.

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<sup>9</sup> See Explanation to Clause 49 I(A)(iv) given above in this page

8.6.2 The term 'promoter' has been defined in Explanation I in paragraph 6.8.3.2 of the SEBI (Disclosure and Investor Protection) Guidelines, 2000<sup>10</sup>. The same term has also been differently defined in Regulation 2(1)(h) of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997<sup>11</sup>. Further the term 'promoter' has also been defined in Clause 4 (12) of the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999<sup>12</sup>.

8.6.3 Also, such independent director should not be a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director and should not also be a substantial shareholder of the company. In determining 'not a substantial shareholder', he should not own 2% or more of the block of voting shares. For this purpose, reference can be made to Section 299 of the Companies Act, 1956.

8.6.4 According to Section 2(41) of the Companies Act, 1956, 'relative' means, with reference to any person, any one who is related to such person in any of the ways specified in Section 6, and no others. Further according to Section 6 of the Companies Act, 1956, a person shall be deemed to be a relative of another if, and only if:

- (a) they are members of a Hindu Undivided Family; or
- (b) they are husband and wife; or
- (c) the one is related to the other in the manner indicated in schedule 1A<sup>13</sup>.

#### 8.7. (B) *Non-executive Directors' Compensation and Disclosures*

- (i) *All fees / compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.*

*<sup>14</sup>Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 1956 for payment of sitting fees without approval of the Central Government.*

*[Clause 49 I (B)]*

#### 8.8 The auditor –

- should ascertain from the minutes of the Board of Directors' meeting, shareholders' meetings, relevant agenda papers, notices, explanatory statements etc., whether remuneration of non-executive directors has been decided by the Board of directors and previous approval of the shareholders in general meeting have been obtained.

<sup>10</sup> See Appendix G.

<sup>11</sup> See Appendix G.

<sup>12</sup> See Appendix G.

<sup>13</sup> See Appendix H.

<sup>14</sup> Inserted by SEBI Circular dt 13<sup>th</sup> January, 2006 – See Appendix F.

### III.224 Auditing Pronouncements

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- May note that no approval from the Central Government is required so long as the remuneration is within the limits prescribed in Schedule XIII to the Companies Act, 1956.
- May note that in regard to sitting fees payable to non-executive directors, prior approval in general meeting will not be required if made within the limits prescribed under the Companies Act, 1956.
- Should also verify whether the remuneration is in compliance with Section 198, 309, 314, 349 and 350 of the Companies Act, 1956 and whether the stock options that are granted to the non-executive directors are in accordance with SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.
- Should further refer to the Articles of Association of the Company wherever applicable.
- Should examine the report of the Board of directors on Corporate Governance to be included in the annual report of the company and ascertain whether the same contains the disclosures required of remuneration to non-executive directors. The auditor should correlate this data with that contained in the financial statements.

8.9 Since Clause 49 I (B) (i) refers to stock options that can be granted to non-executive directors, reference may be made to ICAI Guidance Note on Accounting for Employee Share-based Payments which defines the following terms:

- Employee Stock Option plan is a plan under which the enterprise grants Employee Stock Options.
- Employee Stock Option is a contract that gives the employees of the enterprise the right, but not the obligation, for a specified period of time, to purchase or subscribe to the shares of the enterprise at a fixed or determinable price.
- Employee Stock Purchase Plan is a plan under which the enterprise offers shares to its employees as part of a public issue or otherwise.

8.10 Where application of this clause requires the value of ESOP to be determined, the services of expert may have to be utilized. In this regard, reference may be made to SA 620 dealing with 'Using the Work of an Expert'

#### 8.11 I (C) *Other provisions as to Board and Committees*

- (i) *The board shall meet at least four times a year, with a maximum time gap of four months<sup>15</sup> between any two meetings. The minimum information to be made available to the board is given in Annexure– IA<sup>16</sup>.*
- (ii) *A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a*

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<sup>15</sup> Substituted in place of 'three months' by SEBI Circular dt. 13<sup>th</sup> January, 2006 – See Appendix F.

<sup>16</sup> Annexure 1A.

*director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.*

**Explanation:**

1. *For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.*
  2. *For the purpose of reckoning the limit under this sub-clause, Chairmanship / membership of the Audit Committee and the Shareholders' Grievance Committee alone shall be considered.*
- (iii) *The Board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliances.*

**[Clause 49 I (C)]**

8.12 Section 285 of the Companies Act, 1956 is reproduced hereunder:

***"S.285. Board to meet at least once in every three calendar months-*** *In the case of every company, a meeting of its Board of Directors shall be held at least once in every three months and at least four such meetings shall be held in every year.*

***Provided that the Central Government may, by notification in the Official Gazette, direct that the provisions of this section shall not apply in relation to any class of companies or shall apply in relation thereto subject to such exceptions, modifications or conditions as may be specified in the notification".***

8.13 Clause 49 and Section 285 stipulate that the Board meeting shall be held at least four times a year. The further requirement of Clause 49 is that the maximum time gap between any two meetings should not exceed four<sup>17</sup> months. The requirement under the Companies Act, 1956 is that the Board meeting would be held at least once in every three months.

8.14 The auditor should ascertain from the minutes book of the Board meetings whether Board meetings were held at least four times a year, with a maximum time gap of four<sup>18</sup> months between any two meetings. The auditor should also ascertain whether minimum information was made available to the Board as given in Annexure – 1C<sup>19</sup> to Clause 49 of the Listing Agreement.

8.15 The auditor should also ascertain that a director of the Company is not a member in more than ten committees or is acting as chairman of more than five committees across all

<sup>17</sup> Substituted in place of 'three months' by SEBI Circular dt. 13<sup>th</sup> January, 2006 – See Appendix F.

<sup>18</sup> *ibid.*

<sup>19</sup> Annexure – 1C.

companies in which he is a director. A suitable declaration from the management and / or director should be obtained to this effect. This information should be verified from the mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies as well as from the changes notified by every director when they take place. The Explanation (1) to Clause 49 (1) (C) (ii) clarifies that the limit of the committees on which a director can serve would comprise of all public limited companies, whether listed or not and excluding private limited companies, foreign companies and companies which are granted license under section 25 of the Companies Act, 1956. Further Explanation (2) clarifies that only two committees namely Audit Committee, and Shareholders' Grievance Committee shall be considered for the purpose of limit.

8.16 For the purpose of reviewing compliance reports of all laws applicable to the company, the said reports prepared by the company as well as steps taken by the company to rectify instances of non-compliances, the auditor should take into consideration SA 250, dealing with consideration of Laws and Regulations in an Audit of Financial Statements. It is the management's responsibility to ensure that company operations are conducted in accordance with Laws and Regulations. The responsibility for the prevention and detection of non-compliance rests with the management. The auditor's responsibility is limited to verification that management has taken suitable steps and has put in place policies and procedures to ensure compliance with laws and regulations and to detect deviation from such procedures.

#### 8.17 I (D) Code of Conduct

- (i) *The Board shall lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.*
- (ii) *All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by the CEO.*

**Explanation:** *For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.*

**[Clause 49 I (D)]**

8.18 The auditor should ascertain whether the Board of Directors of the company has laid down a code of conduct for all Board members and senior personnel of the company and obtain a copy of the same. He should also verify whether all Board members and senior management personnel have affirmed compliance with the code on an annual basis and whether the code has been posted on company's website.

## 9. AUDIT COMMITTEE

### 9.1 II(A) Qualified and Independent Audit Committee

*A qualified and independent audit committee shall be set up giving the terms of reference subject to the following:*

- (i) *The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.*
- (ii) *All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.*

**Explanation 1:** *The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.*

**Explanation 2:** *A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.*

- (iii) *The Chairman of the Audit Committee shall be an independent director;*
- (iv) *The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;*
- (v) *The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;*
- (vi) *The Company Secretary shall act as the secretary to the committee.*

**[Clause 49-II (A)]**

## 9.2 II(B) Meeting of Audit Committee

*The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.*

**[Clause 49 II (B)]**

9.3 Section 292A of the Companies Act, 1956 relating to Audit Committee is reproduced herein below:

### **"Section 292A – Audit Committee**

- (1) *Every public company having paid-up capital of not less than five crores of rupees shall constitute a committee of the Board known as "Audit Committee" which shall consist of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors.*
- (2) *Every Audit Committee constituted under sub-section (1) shall act in accordance with terms of reference to be specified in writing by the Board.*

### III.228 Auditing Pronouncements

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- (3) *The members of the Audit Committee shall elect a chairman from amongst themselves.*
- (4) *The annual report of the company shall disclose the composition of the Audit Committee.*
- (5) *The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.*
- (6) *The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.*
- (7) *The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.*
- (8) *The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.*
- (9) *If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefor and communicate such reasons to the shareholders.*
- (10) *The chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.*
- (11) *If a default is made in complying with the provisions of this section, the company, and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees, or with both”.*

The comparative chart showing the requirements under Clause 49 and Section 292A relating to audit committee is tabulated herein below:

<i>Clause 49 of the Listing Agreement</i>	<i>Section 292A of the Companies Act, 1956</i>
(1) (a) All companies seeking listing for the first time, at the time of seeking in principle approval for such listing and (b) All existing listed companies with a paid-up capital of Rs.3 Crores and above or net worth of Rs. 25 crores or more at any time in the history of the company are required to set up an audit committee.	1. Every public company having paid-up capital of not less than five crores of rupees shall constitute an audit committee immediately on the enactment of Companies (Amendment) Act, 2000, i.e. with effect from 13 <sup>th</sup> December, 2000.

2. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.	2. The audit committee shall have minimum three directors of which two-third of the total number of such directors shall be directors other than managing or whole-time directors.
3. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.	3. No such reference is contained in the Companies Act, 1956.
4. The Chairman of the audit committee shall be an "independent" director and shall be present at Annual General Meeting to answer queries of the shareholders.	4. The members of the audit committee shall elect a chairman from amongst themselves. The Chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.
5. A representative of the external auditor, when required shall be present as an invitee for the meetings of the audit committee. The audit committee may invite such of the executives to be present at the meetings of the committee. The Finance Director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee.	5. The Auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the audit committee but shall not have the right to vote.
6. The Company Secretary shall act as Secretary to the audit committee.	6. No such reference is contained in the Companies Act, 1956.

The following additional requirements are stipulated as per Clause 49 of the Listing Agreement on which Section 292A (relating to audit committee) is silent:

- (i) The audit committee may invite such of the executives, as it considers appropriate (and particularly head of the finance function) to be present at the meeting of the committee, but on occasions, it may also meet without the presence of any executives of the company.
- (ii) The company secretary shall act as secretary to the committee.
- (iii) The audit committee shall meet at least four times in a year. The gap between two meetings should not be more than four months.

### III.230 Auditing Pronouncements

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- (iv) The quorum of the audit committee shall be two members or one-third of the members of the audit committee whichever is higher and minimum of two independent directors be present.
- (v) The powers and role of the audit committee are elaborately contained in Clause 49 II (C) & (D).
- (vi) All members of the audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

The following additional requirements are stipulated as per Section 292A the Companies Act, 1956 (relating to audit committee) on which Clause 49 of the Listing Agreement is silent:

- (i) The audit committee constituted shall act in accordance with terms of reference to be specified in writing by the Board.
- (ii) The recommendations of the audit committee on any matter relating to financial management, including the audit report, shall be binding on the Board.
- (iii) If the Board does not accept the recommendations of the audit committee, it shall record the reasons therefor and communicate such reasons to the shareholders.

9.4 The auditor should ascertain from the minutes book of the Board meetings whether a qualified and independent audit committee is set up which comprises of minimum three members. The auditor should ascertain whether two-thirds of the members of audit committee are independent directors and whether all members of audit committee are financially literate and at least one member has accounting or related financial management expertise. The term "financially literate"<sup>20</sup> means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

9.5 The auditor should ascertain from the minute book of the audit committee whether the audit committee has met at least four times in a year and not more than 4 months have elapsed between two meetings.

9.6 The auditor should ascertain from the minute book of the audit committee whether quorum i.e. two members or one-third of the members of the audit committee, whichever is higher with a minimum of two independent directors was present in every meeting of the audit committee.

9.7 The auditor should ascertain whether the Chairman of the Audit Committee is an independent director. The expression "independent director" has been discussed in Clause 49 (I) (A) (iii) vide paragraph 8.2<sup>21</sup>.

9.8 The auditor should ascertain from the annual general meeting (herein after referred to as AGM) attendance book and minutes book whether the chairman of the audit committee was present at such meeting to answer shareholders' queries. In case the Chairman has not been present at the AGM, auditor should ensure that this is suitably disclosed. The AGM of the

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<sup>20</sup> As given in Explanation 1 to Clause 49 II (A) dealing with Qualified and Independent Audit Committee.

<sup>21</sup> In respect of Board of Directors.

financial year which is under audit would be held subsequent to the auditor submitting the certificate of compliance of conditions of corporate governance and hence, the requirement would be to verify this condition with reference to the last AGM held.

9.9 The auditor should ascertain whether there is a practice of inviting the executives (and particularly the head of the finance function) in the audit committee meetings and he should further ascertain from the minutes book of the audit committee whether such executives did attend the audit committee meetings. His presence at such audit committee meetings (pursuant to Section 292A) would be required only when he has been invited to, duly given notice of such meeting

9.10 The auditor should ascertain from the minutes book of the audit committee, whether the finance director, head of internal audit representative of the statutory auditor when required was present as invitee in the meetings of the audit committee.

#### **9.11 II(C) Powers of Audit Committee**

*The audit committee shall have powers, which should include the following:*

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

**[Clause 49 II (C)]**

9.12 The auditor should check whether the terms of reference of the audit committee have been suitably framed mentioning the above powers. It is mandatory for the above-mentioned four powers to be vested in the Audit Committee. The Board may delegate / vest further powers to the committee. Further it may be noted that the four powers as mentioned above are only illustrative and not exhaustive.

#### **9.13 II(D) Role of Audit Committee**

*The role of the audit committee shall include the following:*

1. *Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.*
2. *Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.*
3. *Approval of payment to statutory auditors for any other services rendered by the statutory auditors.*
4. *Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:*
  - (a) *Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause 2AA of section 217 of the Companies Act, 1956*

### III.232 Auditing Pronouncements

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- (b) Changes, if any, in accounting policies and practices and reasons for the same*
  - (c) Major accounting entries involving estimates based on the exercise of judgment by management*
  - (d) Significant adjustments made in the financial statements arising out of audit findings*
  - (e) Compliance with listing and other legal requirements relating to financial statements*
  - (f) Disclosure of any related party transactions*
  - (g) Qualifications in the draft audit report.*
5. *Reviewing, with the management, the quarterly financial statements before submission to the board for approval*
  6. *Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.*
  7. *Reviewing the adequacy of internal audit function, if any including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.*
  8. *Discussion with internal auditors any significant findings and follow up there on.*
  9. *Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.*
  10. *Discussion with statutory auditors before the audit commences about nature and scope of audit as well as post-audit discussion to ascertain any area of concern.*
  11. *To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.*
  12. *To review the functioning of the Whistle Blower mechanism, in case the same is existing.*
  13. *Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.*

**Explanation (i):** *The term "related party transactions" shall have the same meaning as contained in the Accounting Standard 18, "Related Party Transactions", issued by the Institute of Chartered Accountants of India.*

**Explanation (ii):** *If the company has set up an audit committee pursuant to provision of the Companies Act, the said audit committee shall have such additional functions / features as is contained in this clause.*

**[Clause 49 II (D)]**

9.14 The sub-section 6 & 7 of Section 292A are reproduced hereunder which specify the functions of the Audit Committee:

**"S.292A – Audit Committee**

- (6) *The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.*
- (7) *The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary".*

9.15 The auditor should ascertain from the minutes of the Board meeting whether the terms of reference of the audit committee inter alia include the power, which are referred to in Clause 49 II (C) and also matters which are referred to in Clause 49 II (D) in order to enable the audit committee to effectively carry out the role assigned to it.

**9.16 II(E) Review of information by Audit Committee**

*The Audit Committee shall mandatorily review the following information:*

1. *Management discussion and analysis of financial condition and results of operations;*
2. *Statement of significant related party transactions (as defined by the audit committee), submitted by management;*
3. *Management letters / letters of internal control weaknesses issued by the statutory auditors;*
4. *Internal audit reports relating to internal control weaknesses; and*
5. *The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.*

**[Clause 49 II (E)]**

9.17 The auditor should ascertain from the minutes book of the audit committee and other sources like agenda papers, etc. whether the audit Committee has reviewed the above-mentioned information. The auditor should ascertain whether as a part of directors' report or as an addition thereto, a management discussion and analysis report forms part of the annual report to the shareholders. Under the old Clause 49, this was specifically mandated, but now not spelt out clearly. The auditor should further ascertain whether the management discussion and analysis includes discussion on the matters stipulated in this sub-clause.

9.18 Where certain deficiencies or adverse findings are noted by the audit committee, the auditor will be required to see that these have been suitably dealt with by the management in the Report on Corporate Governance.

9.19 The auditor should ascertain that the information reviewed by the Audit Committee is consistent with the reporting in the financial statements including those drawn up giving segment wise break-up for compliance of AS 17 (Segment Reporting)

9.20 III. *Subsidiary Companies*

- (i) *At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non listed Indian subsidiary company.*
- (ii) *The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.*
- (iii) *The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.*

**Explanation 1:** *The term "material non-listed Indian subsidiary" shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated turnover or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.*

**Explanation 2:** *The term "significant transaction or arrangement" shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.*

**Explanation 3:** *Where a listed holding company has a listed subsidiary which is itself a holding company, the above provisions shall apply to the listed subsidiary insofar as its subsidiaries are concerned.*

**[Clause 49 (III)]**

9.21 Clause 49 III (i) requires the appointment of at least one of the independent director of a holding company to be appointed as a director of a material non-listed Indian subsidiary company. The concept of "material" non-listed subsidiary is explained in Explanation 1 under the said clause.

9.22 In regard to taking note of the proceedings of the Board of the unlisted company, Clause 49 III (iii) requires the minutes of the Board of every unlisted subsidiary to be placed before the Board of the holding company. Apart from the above, the management of the holding company should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company. This applies only in regard to "significant transaction or arrangement" the meaning of which is given in Explanation 2 under the clause.

9.23 Reading the Explanation 2 in totality, it would be seen that the disclosure to the Board of the holding company would apply only where such significant transaction or arrangement are entered into by a company which is a material unlisted subsidiary as mentioned above.

9.24 It may further be noted that the plain reading of Explanation 2 would indicate that the least of total revenues, total expenses, total assets or total liabilities of the immediately

preceding accounting year are to be considered as the basis for computing benchmark of 10% thereof. However, the use of the words 'or' coupled with 'as the case may be' would support the more logical view that one has to apply the test comparing with like items. For example a capital expenditure has to be compared with aggregate capital expenditure for the year. When making the comparison of any transaction with 'total revenues', "total expenses" etc., one may take into consideration the total revenue or expenditure 'likely to' arise for the entire financial year and not necessarily the aggregate expenditure incurred.

9.25 Clause 49 III (ii) requires the audit committee of the listed holding company to review the financial statements and in particular, the investments made by the unlisted subsidiary company would apply all unlisted subsidiary companies. This is required in regard to all unlisted subsidiaries, without reference to materiality or place of incorporation etc. Where however the subsidiary of a listed company is itself a listed company, the Explanation 3 would apply.

#### 9.26 IV. Disclosures

##### *IV(A) Basis of related party transactions*

- (i) *A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.*
- (ii) *Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.*
- (iii) *Details of material individual transactions with related parties or others, which are not on an arm's length basis should be placed before the audit committee, together with Management's justification for the same.*

**[Clause 49 IV (A)]**

9.27 The Report on Corporate Governance requires disclosure of certain transactions with related parties or transactions, which may not be 'arms length' transactions. The auditor is required to verify whether the management has placed periodically the information before the Audit Committee.

9.28 The transactions required to be disclosed by the management are as under:

- (a) Transactions with related parties; entered into in the ordinary course of business are to be disclosed in summary form (Grouping them into broad categories of the transactions).
- (b) Transactions with related parties which do not fall within the normal business transactions (and are therefore not covered in (a) above) are to be disclosed individually if such transactions are material transactions.
- (c) Transactions with any party (related or otherwise), which are not considered as arm's length transactions, are to be disclosed individually if such transactions are material transactions.

9.29 The auditor has to verify whether a transaction is a related party transaction as per AS 18 (Related Party Disclosures). As per AS 18, parties are considered to be related if at any time

### III.236 Auditing Pronouncements

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during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and / or operating decisions. For the purpose of carrying out verification, reference may be made to SA 550 (Related Parties).

9.30 Materiality depends on the size and nature of the item judged in the particular circumstances.

#### 9.31 *IV(B) Disclosure of Accounting Treatment*

*Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.*

*[Clause 49 IV (B)]*

9.32 In this regard the auditor has to refer to Sections 211(3B), 217(2AA) and 227 of the Companies Act, 1956. Also the auditor should refer to the CEO / CFO certification given under Clause 49 (IV).

#### 9.33 *IV(C) Board Disclosures – Risk management*

*The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.*

*[Clause 49 IV (C)]*

9.34 The auditor should ascertain whether the executive management has a proper defined framework for risk management and its control. This would involve defining such framework on the lines illustrated in Appendix – B<sup>22</sup>. For a broad reference for assessment of risk etc., and techniques of assessment, he has to further ascertain that such framework in terms of procedure has been informed to the Board members. The evaluation of internal control and risk management is a part of the audit process as mentioned in the auditing standards.

9.35 The risk management framework provides an integrated approach in identifying, assessing, prioritizing, mitigating, monitoring and reporting business risks across the organization. The company is required to develop a framework on the basis of which executive management is required to assess risks and minimize the impact of risk. Further, these risk management procedures are required to be reviewed periodically by the management.

9.36 The existence of a risk management framework may be evidenced by the following parameters<sup>23</sup>. Some of these are tangible and can be evidenced by appropriate documentation. Whereas intangibles are concerned, the existence of it needs to be ascertained through enquiries and interviews. Further the auditor should also ensure that the management has effectively implemented the risk management framework and that it is

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<sup>22</sup> See Appendix B.

<sup>23</sup> See Appendix-B.

applied to activities and processes of the business and communicated throughout the organization.

**9.37 IV(D) Proceeds from Public Issues, Rights Issues, Preferential Issues etc.**

*When money is raised through an issue (public issues, rights issues, preferential issues etc.), it shall disclose to the Audit Committee, the use / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice and place it before the audit committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.*

**[Clause 49 IV (D)]**

9.38 The object of this sub-clause is to ensure that in case of diversion of funds from the proceeds of issues<sup>24</sup>, it should be appropriately brought to the notice of audit committee for suitable action to be taken. Also, it is desirable that quarterly and yearly report on the same is placed before the audit committee for its review and action if any. It is to be noted that the disclosure under the sub-clause should continue to be made till such time the issue money is utilized in full and the statutory auditors certify the said statement. Further it may be noted that statement shall pertain only to the year in which money has been raised or till such time the money is fully spent whichever is later.

9.39 The following procedure may be noted in carrying out the aforesaid action on the uses and applications of funds from proceeds from public issues etc:

- The quarterly report on the uses / application of funds shall be placed before the Audit Committee by the management.
- Diversion of funds, if any shall be brought to the attention of the Audit Committee by the management
- The management would then obtain the duly certified statement from the statutory auditors of the company and place it before the Audit Committee to enable the discontinuance of reporting thereafter.

**9.40 IV(E) Remuneration of Directors**

- (i) *All pecuniary relationship or transactions of the non-executive directors vis-à-vis the company shall be disclosed in the Annual Report.*

<sup>24</sup> Issues would include public issues of depository receipts, Foreign Currency Convertible Bonds (FCCB) referred to by various SEBI Regulations.

- (ii) Further the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the Annual Report:
  - (a) All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc.
  - (b) Details of fixed component and performance linked incentives, along with the performance criteria.
  - (c) Service contracts, notice period, severance fees.
  - (d) Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.
- (iii) The company shall publish its criteria of making payments to non-executive directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.
- (iv) The company shall disclose the number of shares and convertible instruments held by non-executive directors in the annual report.
- (v) Non-executive directors shall be required to disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.

**[Clause 49 IV (E)]**

9.41 All pecuniary relationship or transactions of the non-executive director *vis-à-vis* the company is required to be disclosed in the annual report. Auditor should check whether the particulars regarding remuneration package of individual directors summarized under major groups have been disclosed in the section in the Corporate Governance of the annual report.

9.42 Sub-Clause (iii) requires the publication of the criteria of making payments to non-executive directors. This implies that the Board or the Remuneration Committee will have to frame a specific policy for such remuneration. Such policy or criteria will have to be published in its annual report. Alternatively, if the same is put up on the company's website, a reference to this disclosure will have to be made in the annual report.

9.43 Companies are required to annually disclose the details relating to shareholding by the non-executive directors. However, non-executive directors shall be required to make such disclosure on one time basis prior to his joining the Board. Further, the notice of general meeting proposing to appoint such Director is required to disclose details of shareholding of the directors in the company. For this purpose, the Director shall make suitable disclosure to the company prior to his appointment and annually.

#### 9.44 IV(F) Management

- (i) *As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:*
- (a) *Industry structure and developments*
  - (b) *Opportunities and Threats*
  - (c) *Segment-wise or product-wise performance*
  - (d) *Outlook*
  - (e) *Risks and concerns*
  - (f) *Internal control systems and their adequacy*
  - (g) *Discussion on financial performance with respect to operational performance*
  - (h) *Material developments in Human Resources / Industrial Relations front, including number of people employed.*
- (ii) *Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)*

**Explanation:** *For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding the Board of Directors). This would also include all members of management one level below the executive directors including all functional heads.*

**[Clause 49 IV (F)]**

9.45 The above information presented by the Management is likely to include non-financial information, which may be outside the area of auditors' expertise. In such situations, the auditor may keep in mind the SA 310 relating to Knowledge of the Business and the fact that he is only required to review the compliance with Disclosure requirements and not verify the particular facts as disclosed by the management.

9.46 The auditor should ascertain that this information [i.e. segment-wise or product-wise performance (sub-clause (iii) as stated above) and considered as a part of Management Discussion and Analysis Report ] is consistent with what is reported in financial statements complying with AS 17 (Segment Reporting) and also as per provisions of Section 211, 217(2AA) and 227 of the Companies Act, 1956.

9.47 IV(G) Shareholders

- (i) *In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:*
  - (a) *A brief resume of the director;*
  - (b) *Nature of his expertise in specific functional areas;*
  - (c) *Names of companies in which the person also holds the directorship and the membership of Committees of the Board; and*
  - (d) *Shareholding of non-executive directors as stated in Clause 49 (IV) (E) (v) above*
- (ii) *Quarterly results and presentations made by the company to analysts shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.*
- (iii) *A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This Committee shall be designated as 'Shareholders / Investors Grievance Committee'.*
- (iv) *To expedite the process of share transfers, the Board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.*

**[Clause 49 IV (G)]**

9.48 The auditor should ascertain from the communications sent, whether in the case of appointment of a new director or re-appointment of a director the shareholders have been provided with the information stipulated in sub-clause (i) as mentioned above.

9.49 The auditor should see that the references contained in the above paragraph are complied therewith.

9.50 The Auditor should ascertain from the company's website whether information like quarterly results, presentation made by the entity to analyst have been put on company's website. In the alternative whether such information has been sent in a form so as to enable the Stock Exchange in which the company's securities are listed to enable such Stock Exchange to put it on its own website. The auditor should also ascertain whether the other information which are mandatorily required to be disclosed to the shareholders as per the Listing Agreement or as per the Companies Act, 1956 are put on company's web-site or alternatively sent in such form to enable the stock exchange on which the company's securities are listed to enable such stock exchange to put it on its own web-site.

9.51 The auditor should ascertain from the minute book of the Board meeting whether a Board committee namely Shareholders / Investors Grievance Committee has been set up under the

chairmanship of a non-executive director to specifically look into the redressing of shareholder and investors complaints like transfer of shares, non receipt of balance sheet, non receipt of declared dividends, etc. Further the auditor should also ascertain from the minute book of the Shareholders / Investors Grievance Committee whether such committee is prima-facie functioning.

9.52 The auditor should also verify from the records of the Shareholders / Investors Grievance Committee as well as from the certificate obtained by the company from SEBI and Stock Exchange(s), if any, as regards the investors grievances pending upto the date of certificate of compliance of conditions of corporate governance.

9.53 The auditor should ascertain from the minute book of the Board meeting whether the company has delegated the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The auditor should also verify from the records maintained to ascertain whether the delegated authority has attended to share transfer formalities at least once in a fortnight. The auditor may verify whether any transfer request are pending for more than a fortnight and are not attended to in terms of this sub-paragraph.

#### 9.54 *V. CEO / CFO Certification*

*The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:*

- (a) *They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:*
  - (i) *these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;*
  - (ii) *these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.*
- (b) *There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.*
- (c) *They accept responsibility for establishing and maintaining internal controls for financial reporting<sup>25</sup> and that they have evaluated the effectiveness of the internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.*
- (d) *They have indicated to the auditors and the Audit committee:*
  - (i) *significant changes in internal control over financial reporting<sup>26</sup> during the year;*

<sup>25</sup> Inserted by SEBI Circular dt 13<sup>th</sup> January, 2006 – See Appendix F.

<sup>26</sup> Inserted by SEBI Circular dt 13<sup>th</sup> January, 2006 – See Appendix F.

### III.242 Auditing Pronouncements

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- (ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and*
- (iii) instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting<sup>27</sup>.*

**[Clause 49 V]**

9.55 The amendments effected in Clause 49V(c) & (d) clearly bring out that–

- (a) the responsibility entrusted to the CEO / CFO is in relation to establishing and maintaining internal controls for financial reporting.
- (b) The CEO / CFO certificate has to assert that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting.
- (c) The CEO / CFO certificate will further state the manner in which deficiencies (if any) in the design or operation of such internal controls has been disclosed to the auditors and the audit committee.
- (d) The CEO / CFO certification will also state the steps they have taken or propose to take to rectify these deficiencies in the design or operation of such internal controls pertaining to financial reporting.

9.56 In the context of internal controls, the auditor should ensure that –

- (a) the management has institutionalized an internal control framework with respect to financial reporting controls. The framework should be examined in the context of the documentation created for each significant process in terms of the related risk and mitigating control;
- (b) he has further examined whether the assessment process followed for evaluation of controls is reasonable and there is a process by which significant deficiencies as well as steps taken to correct them is communicated to the audit committee and to the auditors; and
- (c) he should also examine whether a process exists in the company whereby all significant changes in the accounting policies and in the system of internal controls are communicated to the audit committee and the auditors.

9.57 The auditor should examine the adequacy of the process followed for issuing the CEO / CFO certificate and should review the same in regard to matters stated in Para 9.52 above and the consideration of the same by the Audit Committee. For this purpose he should refer to the minutes of the Audit Committee.

9.58 In certain situations negative or adverse comment or exclusions / disclaimer contained in the CEO / CFO certificate, the auditor should take cognizance of the same as the circumstances require in the audit report and or the Certificate of Compliance of conditions of Corporate Governance.

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<sup>27</sup> Inserted by SEBI Circular dt 13<sup>th</sup> January, 2006 – See Appendix F.

#### 9.59 *VI. Report on Corporate Governance*

- (i) *There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in Annexure – I C and list of non-mandatory requirements is given in Annexure – I D.*
- (ii) *The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in Annexure - I B. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.*

**[Clause 49(VI)]**

9.60 The auditor should ascertain whether the Board of directors have included in the annual report of the company, a separate section on corporate governance with a detailed compliance report on corporate governance. This would specifically highlight non-compliance of any mandatory requirement. (i.e. which is part of the Listing Agreement) with reasons thereof and also the extent to which the non-mandatory requirements have been adopted. The auditor should also verify whether the suggested list of items to be included in this report as per Annexure - I C<sup>28</sup> of Clause 49 and list of non-mandatory requirements as per Annexure - I D<sup>29</sup> of Clause 49 have been incorporated in such report. *(Circular on Revised Clause 49<sup>30</sup> along with its Annexures<sup>31</sup> is reproduced at the end of this guidance note.*

9.61 Any data in the report on corporate governance should not be inconsistent with that contained in the financial statements.

### 10. MANAGEMENT REPRESENTATIONS

The auditor should consider obtaining management representations on conditions of Corporate Governance in accordance with SA 580, "Management Representations".

### 11. AUDITORS' CERTIFICATE

#### 11.1 *VII. Compliance*

- (1) *The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.*

<sup>28</sup> Refer to Annexure – 1C

<sup>29</sup> Refer to Annexure – 1D

<sup>30</sup> Refer to Annexure - D

<sup>31</sup> Refer to Annexures.

### III.244 Auditing Pronouncements

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- (2) *The non-mandatory requirements given in Annexure – I D may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.*

**[Clause 49(VII)]**

11.2 A draft of the Auditors' Certificate on compliance of conditions of Corporate Governance is given in *Appendix – C*.<sup>32</sup> Depending upon the facts and circumstances, some situations may require an adverse or qualified statement or a disclosure without necessarily making it a subject matter of qualification in the Auditors' Certificate, in respect of compliance of requirements of Corporate Governance for e.g.,

- (a) The number of non-executive directors is less than 50% of the strength of Board of directors.
- (b) A qualified and independent audit committee is not set up.
- (c) The chairman of the audit committee is not an independent director.
- (d) The audit committee does not meet four times a year.
- (e) The necessary powers in terms of Clause 49 II (D) of the Listing Agreement have not been vested by the Board in the audit committee.
- (f) The time gap between two Board meetings is more than four months.
- (g) A director is a member of more than ten committees across all companies in which he is a director.
- (h) The information of quarterly results is neither put on the company's website nor sent in a form so as to enable the Stock Exchange on which the entity's securities are listed to enable such Stock Exchange to put it on its own website.
- (i) The power of share transfer is not delegated to an officer or a committee or to the registrar and share transfer agents.

#### **12. ROLE OF AUDITOR IN AUDIT COMMITTEE & CERTIFICATION OF COMPLIANCE OF CONDITIONS OF CORPORATE GOVERNANCE**

12.1 The amendment to Listing Agreement as well as the Companies Act, 1956 in respect of constitution of audit committee underline the importance of audit process and its contribution to the corporate governance process. Clause 49 stipulates that a representative of the statutory auditor, when required, shall be present as an invitee for the meetings of the audit committee. Section 292A of the Companies Act, 1956 stipulate that the auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.

12.2 The auditor would be informing the audit committee on various matters connected with the audit from time to time. He can contribute significantly in assisting and advising the audit

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<sup>32</sup> Appendix – C.

committee as per the request of the audit committee, particularly in improving corporate governance, oversight of financial reporting process, implementation of accounting policies and practices, compliance with accounting standards, strengthening of the internal control systems in regard to financial reporting and reporting processes.

12.3 The auditor would be devoting substantial professional time in assisting the management and the audit committee to enable it to discharge its functions effectively and in certification of requirements of corporate governance.

12.4 The auditor has to keep in mind that his role is not to drive corporate governance directly by ensuring compliance of the requirements of corporate governance. It is the management responsibility for ensuring the same and in the process he would play a significant role in assisting the management for ensuring better standards of corporate governance.

*Appendix - A*

Sr. No.	Reference No.	Date
1.	SMDRP/POLICY/CIR-10/2000	February 21, 2000
2.	SMDRP/POLICY/CIR-13/2000	March 09, 2000
3.	SMDRP/POLICY/CIR-42/2000	September 12, 2000
4.	SMDRP/POLICY/ CIR- 03/01	January 22, 2001
5.	SMDRP/POLICY/ CIR- 19/01	March 16, 2001
6.	SMDRP/POLICY/ CIR- 53/01	December 31, 2001
7.	SEBI/MRD/SE/31/2003/26/08	August 26, 2003

*Appendix - B*

**DISCLOSURE ABOUT RISK MANAGEMENT**

Sources of Risk	Components of Risk
1. Business Risk	1. Diversifiable Risk (Unsystematic Risk)
2. Financial Risk	2. Non-diversifiable Risk (Systematic Risk)
3. Interest Rate Risk	
4. Liquidity Risk	
5. Market Risk	
6. Event Risk	

**Risk Management Frame work**

Structure	Infrastructure	Processes	Awareness
1. Reporting Lines	1. Methodologies	1. Risk Identification	1. Risk Policies
2. Role and	2. Systems	2. Risk Measurement	2. Risk Strategy

### III.246 Auditing Pronouncements

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Responsibilities	3. Tools	3.Risk Prioritization 4.Risk Monitoring 5.Risk Escalation	3. Risk Appetite of the Organization
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*Appendix - C*

#### CERTIFICATE

To the Members of  
(Name of the Company)

We have examined the compliance of conditions of corporate governance by (name of the company), for the year ended on \_\_\_\_\_, as stipulated in Clause 49 of the Listing Agreement of the said company<sup>@</sup> with stock exchange(s).

The compliance of conditions of corporate governance is the responsibility of the management. Our examination was limited to procedures and implementation thereof, adopted by the company for ensuring the compliance of the conditions of the Corporate Governance. It is neither an audit nor an expression of opinion on the financial statements of the company.

In our opinion and to the best of our information and according to the explanations given to us, [subject to the following:

- 1.
2. ] @@

We certify that the company\* has complied with the conditions of Corporate Governance as stipulated in the abovementioned Listing Agreement.

We state that such compliance is neither an assurance as to the future viability of the company\* nor the efficiency or effectiveness with which the management has conducted the affairs of the company\*.

For and on behalf of  
ABC & Co.  
Chartered Accountants

( )  
Partner / Proprietor  
Membership No.

Place:

Date:

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<sup>@</sup> In the event the entity is not a "company" under the Companies Act, 1956 appropriate reference may be made in place of the word "company"

<sup>@@</sup> Delete, if not applicable

*Appendix - D*

SEBI/CFD/DIL/CG/1/2004/12/10

*October 29, 2004*

The Managing Director / Executive Director / Administrator  
of all the Stock Exchanges

Dear Sir / Madam,

**Sub: Corporate Governance in listed Companies –  
Clause 49 of the Listing Agreement**

1. All Stock Exchanges are hereby directed to amend the Listing Agreement by replacing the existing Clause 49 of the listing agreement (issued vide circulars dated 21st February, 2000, 9th March 2000, 12th September 2000, 22nd January, 2001, 16th March 2001 and 31st December 2001) with the revised Clause 49 given in Annexure I through I D to this circular. SEBI Circular no. SEBI/MRD/SE/31/2003/26/08 dated August 26, 2003 (which has been since deferred) is hereby withdrawn. The revised Clause 49 also specifies the reporting requirements for a company.
2. Please note that this is a master circular which supersedes all other earlier circulars issued by SEBI on Clause 49 of the Listing Agreement.
3. The provisions of the revised Clause 49 shall be implemented as per the schedule of implementation given below:
  - (a) For entities seeking listing for the first time, at the time of seeking in-principle approval for such listing.
  - (b) For existing listed entities which were required to comply with Clause 49 which is being revised i.e. those having a paid up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company, **by April 1, 2005.**

Companies complying with the provisions of the existing Clause 49 at present (issued vide circulars dated 21st February 2000, 9th March 2000, 12th September 2000, 22<sup>nd</sup> January 2001 16th March 2001 and 31st December 2001) shall continue to do so till the revised Clause 49 of the Listing Agreement is complied with or till **March 31, 2005**, whichever is earlier.

4. The companies which are required to comply with the requirements of the revised Clause 49 shall submit a quarterly compliance report to the stock exchanges as per sub Clause VI (ii), of the revised Clause 49, within 15 days from the end of every quarter. The first such report would be submitted for the quarter ending **June 30, 2005**. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.

5. The revised Clause 49 shall apply to all the listed companies, in accordance with the schedule of implementation given above. However, for other listed entities which are not companies, but body corporate (e.g. private and public sector banks, financial institutions,

### III.248 Auditing Pronouncements

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insurance companies etc.) incorporated under other statutes, the revised Clause 49 will apply to the extent that it does not violate their respective statutes and guidelines or directives issued by the relevant regulatory authorities. The revised Clause 49 is not applicable to Mutual Funds.

6. The Stock Exchanges shall ensure that all provisions of the revised Clause 49 have been complied with by a company seeking listing for the first time, before granting the in-principle approval for such listing. For this purpose, it will be considered satisfactory compliance if such a company has set up its Board and constituted committees such as Audit Committee, Shareholders / Investors Grievances Committee etc. in accordance with the revised clause before seeking in-principle approval for listing.

7. The Stock Exchanges shall set up a separate monitoring cell with identified personnel to monitor the compliance with the provisions of the revised Clause 49 on corporate governance. The cell, after receiving the quarterly compliance reports from the companies which are required to comply with the requirements of the revised Clause 49, shall submit a consolidated compliance report to SEBI within 60 days from the end of each quarter.

*Encl: Annexure I, I A, I B, I C & I D*<sup>33</sup>

*Appendix - E*

SEBI/CFD/DIL/CG/1/2005/29/3

*March 29, 2005*

The Managing Director / Executive Director / Administrator  
of all the Stock Exchanges

Dear Sir / Madam,

**Sub: Corporate Governance – Clause 49 of the Listing Agreement**

Please refer to SEBI circular no. SEBI/CFD/DIL/CG/1/2004/12/10 dated October 29, 2004 containing the revised provisions of Clause 49 of the listing agreement.

It has been brought to our notice that a large number of companies are still not in a state of preparedness to be fully compliant with the requirements as contained in the aforesaid circular. As it is our wont that all listed companies and companies desirous of getting listed should achieve best corporate governance status, it was felt that more time should be allowed to them to conform to Clause 49 of the listing agreement as revised in terms of the aforesaid circular. Accordingly, the date for ensuring compliance with the revised Clause 49 of the listing agreement has been now extended upto December 31, 2005.

Yours faithfully,

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<sup>33</sup> Refer to Annexures.

*Appendix - F*

SEBI/CFD/DIL/CG/1/2006/13/1

January 13, 2006

The Managing Director / Executive Director / Administrator of all the Stock Exchanges

Dear Sir / Madam,

**Sub: Corporate Governance in listed Companies – Clause 49 of the Listing Agreement**

SEBI, vide circular SEBI/CFD/DIL/CG/1/2004/12/10 dated October 29, 2004, issued the revised clause 49 of the listing agreement, which was to come into effect by April 1, 2005. Since it was brought to SEBI's notice that a large number of companies were still not in a state of preparedness to be fully compliant with the requirements as contained in the revised clause 49, SEBI extended the date for ensuring compliance with the revised Clause 49 of the listing agreement upto December 31, 2005 vide circular no. SEBI/CFD/DIL/CG/1/2005/29/3 dated March 29, 2005. The revised clause 49 thus has come into effect from January 1, 2006.

SEBI has been in receipt of a number of requests / suggestions to bring about clarifications on certain provisions of the revised Clause 49. After examining the same, it has been decided to make the following changes to certain provisions of the revised clause 49:

- The maximum time gap between two Board meetings has been increased from three months to four months.
- Sitting fees paid to non-executive directors as authorized by the Companies Act, 1956 would not require the previous approval of shareholders.
- Certification of internal controls and internal control systems by CEO / CFO would be for the purpose for financial reporting.

In view of the above, certain changes have to be incorporated in the revised Clause 49, details of which are placed in Annexure I

The Stock Exchanges are advised to accordingly amend the listing agreement with immediate effect.

Yours faithfully,

**ANNEXURE I (to Circular dt. 13<sup>th</sup> January 2006)**

Clause 49 of the Listing Agreement shall be amended as follows:

1. After sub-clause (I)(B), the following proviso shall be inserted, namely:

“Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 1956 for payment of sitting fees without approval of the Central Government.”

### III.250 Auditing Pronouncements

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2. In sub-clause (I)(C), for the words "three months" occurring in the first sentence, the words "four months" shall be substituted;
3. Sub-clause (V)(c) shall be substituted with the following, namely:

"(c) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies."
4. Sub-clause (V)(d) shall be substituted with the following, namely:

"(d) They have indicated to the auditors and the Audit committee

  - (i) significant changes in internal control over financial reporting during the year;
  - (ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting".

#### *Appendix - G*

#### **SEBI (Disclosure and Investor Protection) Guidelines, 2000**

According to the Explanation I in paragraph 6.8.3.2, for the purpose of sub-clause (k) and (l) (of Clause 6.8.3.2) the term "promoter" shall include:

- (a) The person or persons who are in overall control of the company;
- (b) The person or persons who are instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public;
- (c) The person or persons named in the prospectus as promoter(s);

Provided that a director / officer of the issuer company or person, if they are acting as such merely in the professional capacity shall not be included in the Explanation.

#### **Regulation 2(1)(h) of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997**

Promoter means:

- (i) The persons or persons who are in the control of the company, directly or indirectly, whether as a shareholder, director or otherwise; or
- (ii) Person or persons named as promoters in any document of offer of securities to the public or existing shareholders, and includes
  - (a) Where the promoter is an individual:

- (1) a relative of the promoter within the meaning of section 6 of the Companies Act, 1956 (1 of 1956);
- (2) any firm or company, directly or indirectly, controlled by the promoter or a relative of the promoter or a firm or Hindu undivided family in which the promoter or his relative is a partner or a coparcener or a combination thereof;

**Provided** that, in case of a partnership firm, the share of the promoter or his relative, as the case may be, in such firm should not be less than 50%.

(b) where the promoter is a body corporate:

- (1) a subsidiary or holding company of that body; or
- (2) any firm or company, directly or indirectly, controlled by the promoters of that body corporate or by the relative or a firm or Hindu undivided family in which the promoter or his relative is a partner or coparcener or a combination thereof:

**Provided** that, in case of a partnership firm, the share of such promoter or his relative, as the case may be, in such firm should not be less than 50%;]

#### **SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999**

According to Clause 4 (12), "promoters" means:

- (a) The person or persons who are in over all control of the company;
- (b) The person or persons who are instrumental in the formation of the company or programme pursuant to which the shares were offered to the public;
- (c) The person or persons named in the offer document as promoter (s);

**Provided** that a director or officer of the company, if they are acting as such only in their professional capacity will not be deemed to be a promoter.

[**Explanation:** Where a promoter of a company is a body corporate, the promoters of that body corporate shall also be deemed to be promoters of the company].

#### **Appendix - H**

##### **List of relatives as per Schedule 1A to the Companies Act, 1956**

1. Father
2. Mother (including step Mother)
3. Son (including step-Son)
4. Son's wife
5. Daughter including step-daughter
6. Father's father

### III.252 Auditing Pronouncements

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7. Father's mother
8. Mother's mother
9. Mother's father
10. Son's son
11. Son's son's wife
12. Son's daughter
13. Son's daughter's husband
14. Daughter's husband
15. Daughter's son
16. Daughter's son's wife
17. Daughter's daughter
18. Daughter's daughter's husband
19. Brother (including step brother)
20. Brother's wife
21. Sister including step sister
22. Sister's husband.

*Annexure - I*

Clause 49 - Corporate Governance - Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 dated  
October 29, 2004

The company agrees to comply with the following provisions:

**I. Board of Directors**

**(A) Composition of Board**

- (i) The Board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors.
- (ii) Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors.
- (iii) For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who:
  - (a) apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;

- (b) is not related to promoters or persons occupying management positions at the board level or at one level below the board;
- (c) has not been an executive of the company in the immediately preceding three financial years;
- (d) is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
  - (i) the statutory audit firm or the internal audit firm that is associated with the company, and
  - (ii) the legal firm(s) and consulting firm(s) that have a material association with the company.
- (e) is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and
- (f) is not a substantial shareholder of the company i.e. owning two percent or more of the block of voting shares.

**Explanation:** For the purposes of the sub-clause (iii):

- (a) Associate shall mean a company which is an "associate" as defined in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements", issued by the Institute of Chartered Accountants of India.
- (b) "Senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.
- (c) "Relative" shall mean "relative" as defined in section 2(41) and section 6 read with Schedule IA of the Companies Act, 1956.
- (iv) Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be independent directors.

**Explanation:** "Institution" for this purpose means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a "corresponding new bank" as defined in section 2(d) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts]."

#### **(B) Non Executive Directors' Compensation and Disclosures**

All fees / compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

### III.254 Auditing Pronouncements

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<sup>34</sup>Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 1956 for payment of sitting fees without approval of the Central Government.

#### (C) Other Provisions as to Board and Committees

- (i) The board shall meet at least four times a year, with a maximum time gap of four months<sup>35</sup> between any two meetings. The minimum information to be made available to the board is given in Annexure– I A.<sup>36</sup>
- (ii) A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

#### *Explanation:*

1. For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.
2. For the purpose of reckoning the limit under this sub-clause, Chairmanship / membership of the Audit Committee and the Shareholders' Grievance Committee alone shall be considered.
  - (iii) The Board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliances.

#### (D) Code of Conduct

- (i) The Board shall lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.
- (ii) All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by the CEO.

*Explanation:* For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors.. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

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<sup>34</sup> Inserted by SEBI Circular dt. 13<sup>th</sup> January, 2006 – See Appendix F.

<sup>35</sup> Substituted in place of 'three months' by SEBI Circular dt. 13<sup>th</sup> January, 2006 – See Appendix F.

<sup>36</sup> Refer to Annexure – 1A

## II. Audit Committee

### (A) Qualified and Independent Audit Committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

- (i) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.
- (ii) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

*Explanation 1:* The term “financially literate” means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

*Explanation 2:* A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

- (iii) The Chairman of the Audit Committee shall be an independent director;
- (iv) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;
- (v) The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;
- (vi) The Company Secretary shall act as the secretary to the committee.

### (B) Meeting of Audit Committee

The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

### (C) Powers of Audit Committee

The audit committee shall have powers, which should include the following:

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

**(D) Role of Audit Committee**

The role of the audit committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
4. Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:
  - (a) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956
  - (b) Changes, if any, in accounting policies and practices and reasons for the same
  - (c) Major accounting entries involving estimates based on the exercise of judgment by management
  - (d) Significant adjustments made in the financial statements arising out of audit findings
  - (e) Compliance with listing and other legal requirements relating to financial statements
  - (f) Disclosure of any related party transactions
  - (g) Qualifications in the draft audit report.
5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval
6. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.
7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.
8. Discussion with internal auditors any significant findings and follow up there on.
9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
10. Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
11. To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.

12. To review the functioning of the Whistle Blower mechanism, in case the same is existing.
13. Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

**Explanation (i):** The term "related party transactions" shall have the same meaning as contained in the Accounting Standard 18, Related Party Transactions, issued by The Institute of Chartered Accountants of India.

**Explanation (ii):** If the company has set up an audit committee pursuant to provision of the Companies Act, the said audit committee shall have such additional functions / features as is contained in this clause.

#### **(E) Review of Information by Audit Committee**

The Audit Committee shall mandatorily review the following information:

1. Management discussion and analysis of financial condition and results of operations;
2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;
3. Management letters / letters of internal control weaknesses issued by the statutory auditors;
4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee

#### **III. Subsidiary Companies**

- (i) At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non listed Indian subsidiary company.
- (ii) The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.
- (iii) The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

**Explanation 1:** The term "material non-listed Indian subsidiary" shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated turnover or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.

**Explanation 2:** The term "significant transaction or arrangement" shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or

total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.

*Explanation 3:* Where a listed holding company has a listed subsidiary which is itself a holding company, the above provisions shall apply to the listed subsidiary insofar as its subsidiaries are concerned.

#### IV. Disclosures

##### (A) Basis of related party transactions

- (i) A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.
- (ii) Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.
- (iii) Details of material individual transactions with related parties or others, which are not on an arm's length basis should be placed before the audit committee, together with Management's justification for the same.

##### (B) Disclosure of Accounting Treatment

Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.

##### (C) Board Disclosures – Risk management

The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

##### (D) Proceeds from public issues, rights issues, preferential issues etc.

When money is raised through an issue (public issues, rights issues, preferential issues etc.), it shall disclose to the Audit Committee, the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice and place it before the audit committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.

##### (E) Remuneration of Directors

- (i) All pecuniary relationship or transactions of the non-executive directors *vis-à-vis* the company shall be disclosed in the Annual Report.

- (ii) Further the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the Annual Report:
  - (a) All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc.
  - (b) Details of fixed component and performance linked incentives, along with the performance criteria.
  - (c) Service contracts, notice period, severance fees.
  - (d) Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.
- (iii) The company shall publish its criteria of making payments to non-executive directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.
- (iv) The company shall disclose the number of shares and convertible instruments held by non-executive directors in the annual report.
- (v) Non-executive directors shall be required to disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.

**(F) Management**

- (i) As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:
  - (a) Industry structure and developments.
  - (b) Opportunities and Threats
  - (c) Segment-wise or product-wise performance
  - (d) Outlook
  - (e) Risks and concerns
  - (f) Internal control systems and their adequacy
  - (g) Discussion on financial performance with respect to operational performance
  - (h) Material developments in Human Resources / Industrial Relations front, including number of people employed.
- (ii) Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

### III.260 Auditing Pronouncements

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**Explanation:** For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding the Board of Directors).

This would also include all members of management one level below the executive directors including all functional heads.

#### (G) Shareholders

- (i) In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:
  - (a) A brief resume of the director;
  - (b) Nature of his expertise in specific functional areas;
  - (c) Names of companies in which the person also holds the directorship and the membership of Committees of the Board; and
  - (d) Shareholding of non-executive directors as stated in Clause 49 (IV) (E) (v) above
- (ii) Quarterly results and presentations made by the company to analysts shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.
- (iii) A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This Committee shall be designated as 'Shareholders / Investors Grievance Committee'.
- (iv) To expedite the process of share transfers, the Board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

#### V. CEO / CFO Certification

The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

- (a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:
  - (i) these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;
  - (ii) these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.
- (b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

- (c) They accept responsibility for establishing and maintaining internal controls for financial reporting<sup>37</sup> and that they have evaluated the effectiveness of the internal control systems of the company pertaining to financial reporting<sup>38</sup> and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.
- (d) They have indicated to the auditors and the Audit committee
- (i) significant changes in internal control over financial reporting<sup>39</sup> during the year;
  - (ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
  - (iii) instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting<sup>40</sup>.

#### VI. Report on Corporate Governance

- (i) There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in Annexure- I C<sup>41</sup> and list of non-mandatory requirements is given in Annexure – I D<sup>42</sup>.
- (ii) The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in Annexure I B<sup>43</sup>. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company

#### VII. Compliance

- (1) The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.
- (2) The non-mandatory requirements given in Annexure – I D<sup>44</sup> may be implemented as per the discretion of the company. However, the disclosures of the compliance with

<sup>37</sup> Inserted by SEBI Circular dt 13<sup>th</sup> January, 2006 – See Appendix F.

<sup>38</sup> Inserted by SEBI Circular dt 13<sup>th</sup> January, 2006 - See Appendix F.

<sup>39</sup> Inserted by SEBI Circular dt 13<sup>th</sup> January, 2006 - See Appendix F.

<sup>40</sup> Inserted by SEBI Circular dt 13<sup>th</sup> January, 2006 - See Appendix F.

<sup>41</sup> See Annexure - IC.

<sup>42</sup> See Annexure – 1D.

<sup>43</sup> See Annexure – 1B.

<sup>44</sup> See Annexure – 1D.

### III.262 Auditing Pronouncements

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mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

*Annexure - IA*

#### Information to be placed before Board of Directors

1. Annual operating plans and budgets and any updates
2. Capital budgets and any updates
3. Quarterly results for the company and its operating divisions or business segments
4. Minutes of meetings of audit committee and other committees of the board
5. The information on recruitment and remuneration of senior officers just below the board level, including appointment or removal of Chief Financial Officer and the Company Secretary
6. Show cause, demand, prosecution notices and penalty notices which are materially important
7. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems
8. Any material default in financial obligations to and by the company, or substantial nonpayment for goods sold by the company
9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgment or order which, may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company
10. Details of any joint venture or collaboration agreement
11. Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property
12. Significant labour problems and their proposed solutions. Any significant development in Human Resources / Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme etc
13. Sale of material nature, of investments, subsidiaries, assets, which is not in normal course of business
14. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material
15. Non-compliance of any regulatory, statutory or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer etc.

*Annexure - IB*

**Format of Quarterly Compliance Report  
on Corporate Governance**

Name of the Company:

Quarter ending on:

Particulars	Clause of Listing Agreement	Compliance Status Yes / No	Remarks
<b>I. Board of Directors</b>	49 I		
(A) Composition of Board	49(IA)		
(B) Non-executive Directors' compensation & disclosures	49 (IB)		
(C) Other provisions as to Board and Committees	49 (IC)		
(D) Code of Conduct 49(ID)			
<b>II. Audit Committee</b>	49 (II)		
(A) Qualified & Independent Audit Committee	49 (IIA)		
(B) Meeting of Audit Committee	49 (IIB)		
(C) Powers of Audit Committee	49 (IIC)		
(D) Role of Audit Committee	49 (IIE)		
<b>III. Subsidiary Companies</b>	49 (IV)		
<b>IV. Disclosures</b>	49 (IV)		
(A) Basis of related party transactions	49 (IVA)		
(B) Board Disclosures	49 (IVB)		
(C) Proceeds from public issues, rights issues, preferential issues etc.	49 (IVC)		
(D) Remuneration of Directors	49 (IVD)		
(E) Management	49 (IVE)		
(F) Shareholders	49 (IVF)		
<b>V. CEO / CFO Certification</b>	49 (V)		
<b>VI. Report on Corporate Governance</b>	49 (VI)		
<b>VII. Compliance</b>	49 (VII)		

**Note:**

- (1) The details under each head shall be provided to incorporate all the information required as per the provisions of the Clause 49 of the Listing Agreement
- (2) In the column No.3, compliance or non-compliance may be indicated by Yes / No / N.A.. For example, if the Board has been composed in accordance with the Clause 49 I of the Listing Agreement, "Yes" may be indicated. Similarly, in case the company has no related party transactions, the words "N.A." may be indicated against 49 (IV A)
- (3) In the remarks column, reasons for non-compliance may be indicated, for example, in case of requirement related to circulation of information to the shareholders, which would be done only in the AGM / EGM, it might be indicated in the "Remarks" column as – "will be complied with at the AGM". Similarly, in respect of matters which can be complied with only where the situation arises, for example, "Report on Corporate Governance" is to be a part of Annual Report only, the words "will be complied in the next Annual Report" may be indicated

*Annexure - IC*

**Suggested List of Items to be Included in the Report on Corporate Governance in the Annual Report of Companies**

1. A brief statement on company's philosophy on code of governance.
2. **Board of Directors**
  - (i) Composition and category of directors, for example, promoter, executive, non-executive, independent non-executive, nominee director, which institution represented as lender or as equity investor
  - (ii) Attendance of each director at the Board meetings and the last AGM
  - (iii) Number of other Boards or Board Committees in which he / she is a member or Chairperson
  - (iv) Number of Board meetings held, dates on which held.
3. **Audit Committee**
  - (i) Brief description of terms of reference
  - (ii) Composition, name of members and Chairperson
  - (iii) Meetings and attendance during the year.
4. **Remuneration Committee**
  - (i) Brief description of terms of reference
  - (ii) Composition, name of members and Chairperson
  - (iii) Attendance during the year
  - (iv) Remuneration policy
  - (v) Details of remuneration to all the directors, as per format in main report.

5. ***Shareholders Committee***
  - (i) Name of non-executive director heading the committee
  - (ii) Name and designation of compliance officer
  - (iii) Number of shareholders' complaints received so far
  - (iv) Number not solved to the satisfaction of shareholders
  - (v) Number of pending complaints.
6. ***General Body meetings***
  - (i) Location and time, where last three AGMs held
  - (ii) Whether any special resolutions passed in the previous 3 AGMs
  - (iii) Whether any special resolution passed last year through postal ballot – details of voting pattern
  - (iv) Person who conducted the postal ballot exercise
  - (v) Whether any special resolution is proposed to be conducted through postal ballot
  - (vi) Procedure for postal ballot.
7. ***Disclosures***
  - (i) Disclosures on materially significant related party transactions that may have potential conflict with the interests of company at large
  - (ii) Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years
  - (iii) Whistle Blower policy and affirmation that no personnel has been denied access to the audit committee
  - (iv) Details of compliance with mandatory requirements and adoption of the non-mandatory requirements of this clause.
8. ***Means of communication***
  - (i) Quarterly results
  - (ii) Newspapers wherein results normally published
  - (iii) Any website, where displayed
  - (iv) Whether it also displays official news releases; and
  - (v) The presentations made to institutional investors or to the analysts.
9. ***General Shareholder information***
  - (i) AGM : Date, time and venue
  - (ii) Financial year

- (iii) Date of Book closure
- (iv) Dividend Payment Date
- (v) Listing on Stock Exchanges
- (vi) Stock Code
- (vii) Market Price Data : High., Low during each month in last financial year
- (viii) Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index etc.
- (ix) Registrar and Transfer Agents
- (x) Share Transfer System
- (xi) Distribution of shareholding
- (xii) Dematerialization of shares and liquidity
- (xiii) Outstanding GDRs / ADRs / Warrants or any convertible instruments, conversion date and likely impact on equity
- (xiv) Plant Locations
- (xv) Address for correspondence

*Annexure - ID*

#### **Non-Mandatory Requirements**

##### **(1) The Board**

A non-executive Chairman may be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties.

Independent Directors may have a tenure not exceeding, in the aggregate, a period of nine years, on the Board of a company.

##### **(2) Remuneration Committee**

- (i) The board may set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment
- (ii) To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors may comprise of at least three directors, all of whom should be non-executive directors, the Chairman of committee being an independent director
- (iii) All the members of the remuneration committee could be present at the meeting
- (iv) The Chairman of the remuneration committee could be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

**(3) Shareholder Rights**

A half-yearly declaration of financial performance including summary of the significant events in last six-months, may be sent to each household of shareholders.

**(4) Audit qualifications**

Company may move towards a regime of unqualified financial statements.

**(5) Training of Board Members**

A company may train its Board members in the business model of the company as well as the risk profile of the business parameters of the company, their responsibilities as directors, and the best ways to discharge them.

**(6) Mechanism for evaluating non-executive Board Members**

The performance evaluation of non-executive directors could be done by a peer group comprising the entire Board of Directors, excluding the director being evaluated; and Peer Group evaluation could be the mechanism to determine whether to extend / continue the terms of appointment of non-executive directors.

**(7) Whistle Blower Policy**

The company may establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. This mechanism could also provide for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the Chairman of the Audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organization.