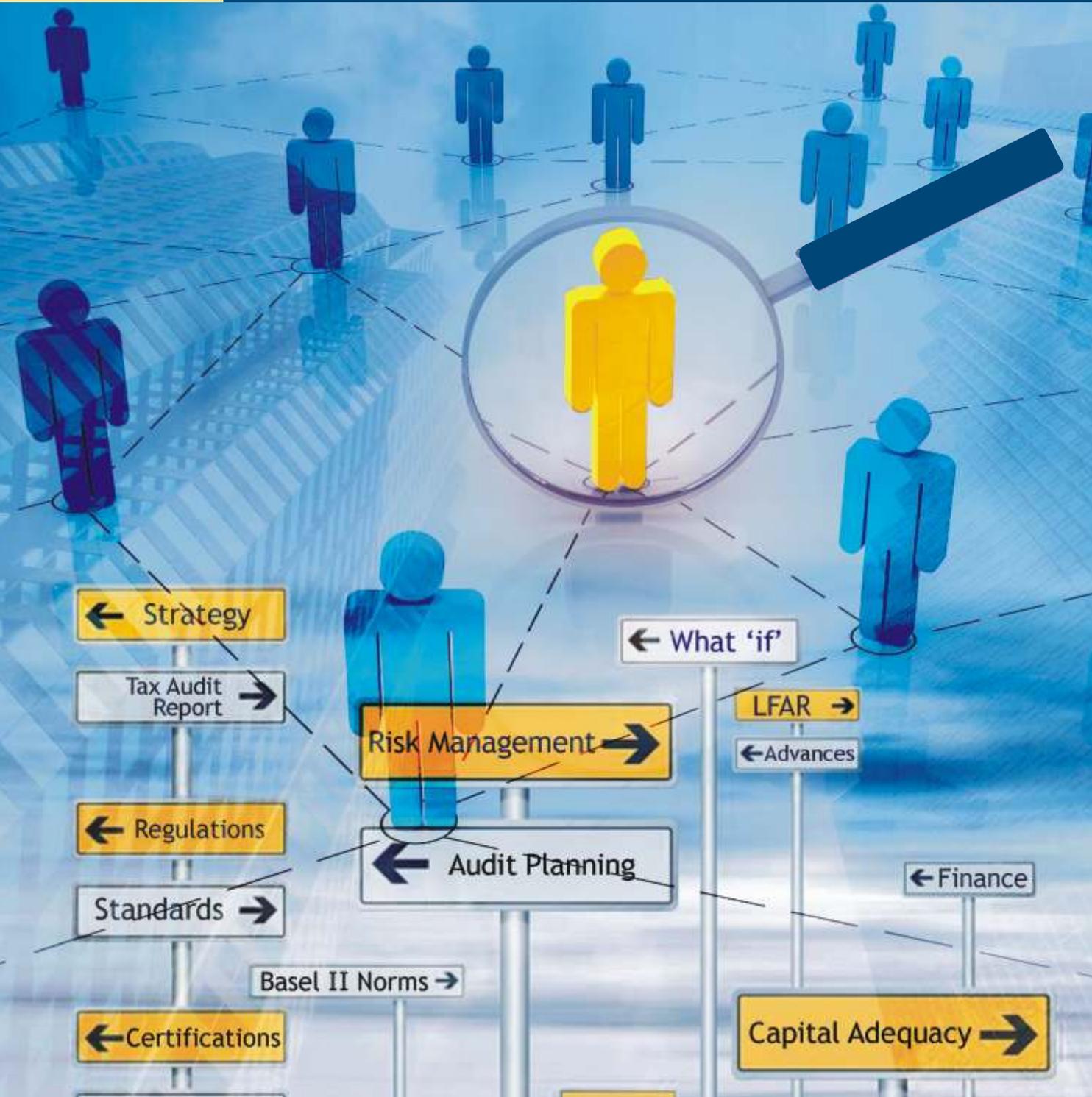




# THE C HARTERED A C C O U N T A N T

JOURNAL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA



## MEETING THE CHALLENGE OF BANK AUDIT

Drive to excel and serve the best interests of the nation coupled with commitment to innovate is the hallmarks of the banking sector in contemporary India. The banking regulator of the country needs to be complemented for its dynamism, vision and open mindedness in paving way for the banking sector in India to come at par with its international counterparts in terms of quantum and quality of products and services offered without sacrificing the banking quintessential of caution. The banking industry in India, therefore, today is an eclectic mix and a fine balance of innovation and caution, tradition and modernity.

A statutory auditor of the banks today, be it at the branch level or the head office level, is faced with challenges of the growing complexities in the operating environment of banks, attributable to not only the transactional, customer and regional spread of the activities of the bank, frequent regulatory directions issued by the banking regulator coupled with increasing use of sophisticated technology not only for providing services to the customers but also for accounting. Further, the last two financial years have been really critical for the global banking industry on account of the global economic crisis, evidencing the fall of some of the leading banks in the developed world. A crisis that owes its origin to the greed and recklessness was not only a body blow to the principles of good corporate governance and accountability but also left all the players in that system, be it the regulators or the bank management or the auditors, red faced.

Whereas the scope of an audit of the financial statements of banks is provided in the relevant legal and regulatory framework, in the above scenario, for the auditors of banks and bank branches to be able to provide quality in the audit services, proper understanding of the bank and its environment and application of that knowledge in audit process is indispensable. The knowledge of the client bank, as the members would appreciate, is not restricted only to the circulars issued by the Reserve Bank of India but extends to the knowledge of the industry, regulatory and other external factors, including the financial reporting framework; nature of the client, viz., its operations,

ownership and governance structure, sources of its finance, selection and application of accounting policies, its objectives and strategies, including those related to its business risks, etc.

Understanding of the internal controls and its components, viz., the control environment, including the communication and enforcement of integrity and ethical values, commitment to competence, HR policies and practices, etc., the risk assessment process employed by the bank, the information system and related business processes relevant to the financial reporting and communication are also essential for the statutory auditors. It may be appreciated that a proper understanding of the client and its environment would help auditors in better and timely identification of risks of material misstatements in the financial statements and reduces the probability of nasty surprises later on.

Appropriate and adequate understanding of the client bank coupled with proper audit planning is a prerequisite for managing the audit activity and getting the most out of the limited human and financial resources and getting over the time constraints and providing quality services. Besides, timely communication of significant audit matters such as control weaknesses will help in timely resolution of issues and in avoiding last minute audit stress. Documentation is also a very critical area in audit. Whereas on the one hand it provides evidence of the audit work done on the other hand it works as a repository for training of audit staff.

The Institute has already issued a range of comprehensive Standards on Auditing, codifying the best practices in the area of auditing. These Standards cover all the critical areas of auditing from planning to obtaining an understanding of the client, responding to assessed risks of misstatements, materiality and its application, using sampling and analytical procedures, audit evidence, written representations, terms of engagement, going concern to reporting and finally, quality control of individual audit assignments. The members must obtain adequate understanding of these Standards and implement the same in their audit work.

- Editorial Board



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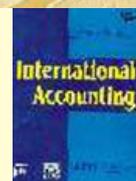


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Note: As this issue of the Journal went into print before presentation of Union Budget 2010-11, we have not been able to cover the Budget in it. The relevant Budget related articles will be carried in April, 2010 issue of this Journal. – EDITOR



**CA. Amarjit Chopra**  
President, ICAI, 2010-11

CA. Amarjit Chopra, a fellow member of The Institute of Chartered Accountants of India (ICAI), with more than three decades of standing, has been elected as the President of the Institute for the year 2010-11 by the twenty first Council on February 12, 2010. He was elected as the Vice-President of the ICAI for the year 2009-2010 by twentieth Council on February 5, 2009. Having a postgraduation from Delhi University in 1973, he qualified as a Chartered Accountant in 1975. He was elected to Northern India Regional Council (NIRC) of the Institute for consecutive two terms, i.e. 1985-1988 and 1988-91, and became its Chairman for 1988-89.

Born in June 1952, he was elected to the Central Council of the ICAI for the first time for the term 1998-2001. During his tenure in the Central Council, he was the Chairman of Accounting Standards Board, Auditing and Assurance Standards Board, and Corporate Laws Committee for two years each and has been the Chairman of Expert Advisory Committee, Financial Reporting Review Board, Committee on Corporate Governance and Committee on Internal Audit for one year each. He has also been the Vice-Chairman of Electoral Reforms

## OUR NEW PRESIDENT

Committee, Ethical Standard Board, Accounting Standards Board, Professional Development Committee in various years. He has also been a member of non-standing committees, namely, Professional Development Committee, Peer Review Board, etc. In his first term as Central Council Member, he was a member of all the three Standing Committees.

He was nominated by the Punjab government on the committee for fixing the fee for the medical institutions.

He was nominated by the ICAI as a member on Secretarial Standards Board of ICSI, Project Implementation Committee of Ministry of Surface & Road Transport, Task Force for Cost Accounting Standards on Arms Length, Banking and Financial Services Sectional Committee-MSD-7, Group initiated by Ministry of Corporate Affairs to review existing Cost Accounting Standards, the business sub-group on XBRL and the Working Group for addressing implementation issues and formulation of operational guidelines relating to Accounting Standard on Financial Instruments: AS 30 by banks and financial institutions constituted by the RBI.

He was nominated to the Consultancy Syndicate and Energy Syndicate of the MOU TASK FORCE for the years 2008-09 and 2009-2010 respectively constituted by the Department of Public Enterprises.

He has represented the ICAI in the National Standards setters meeting of IAASB in London and Brussels as well as on Accounting Standards issues before IASB and UK Accounting Standards Board at London. He has been a speaker in International Conferences on Quality Control of Audit and Corporate Governance convergence with IFRS at Dubai, Karachi, Sri Lanka and London. He is also a Technical Advisor to International Auditing and Assurance Standards Board as the ICAI representative.

An avid writer and prolific speaker on matters of professional interest in more than 1500 programmes organised by the Institute, Regional Councils and their Branches and the study circles, he has also been actively involved in seminars and conferences organised by various Chambers of Commerce.

He has also been actively involved in teaching for more than 20 years in Delhi University and is presently a visiting faculty to management institutions. He has been delivering lectures in training programmes at various banking institutions and at the C&AG Office.

He is on the Board of various reputed companies including RICO Auto Ltd. He was a Central Government nominee on the Board of Bank of Baroda for a period of three years up to October 2009 wherein he was also the Chairman of the Audit Committee. Earlier, he was also nominated to the board of certain companies by banks and financial institutions.

Other areas of his interest include sports, debate and music.

## OUR NEW VICE PRESIDENT

**CA. G. Ramaswamy**, a fellow member of The Institute of Chartered Accountants of India (ICAI), with more than two decades of standing, has been elected as the Vice President of the Institute, for the year 2010-11 by the twenty first Council on February 12, 2010.

During his tenure in the Central Council, he has held important positions in various Standing and Non-standing committees of the ICAI, viz. member of Disciplinary Committee (old and new mechanism) and Examination Committee, etc. He has served as the Chairman of the Fiscal Laws Committee. He has made noteworthy contributions as the Vice Chairman of the Committee on Accounting Standards for Local Bodies, Audit Committee and Committee on International Taxation. He was the nominated member of the SAFA Committee for improvement in transparency, accountability and governance.

CA. G. Ramaswamy has the distinction of being the first nominated member of the Quality Review Board, an external body constituted under the Chartered Accountants (Amendment) Act, 2006 to act as an oversight body of the profession.

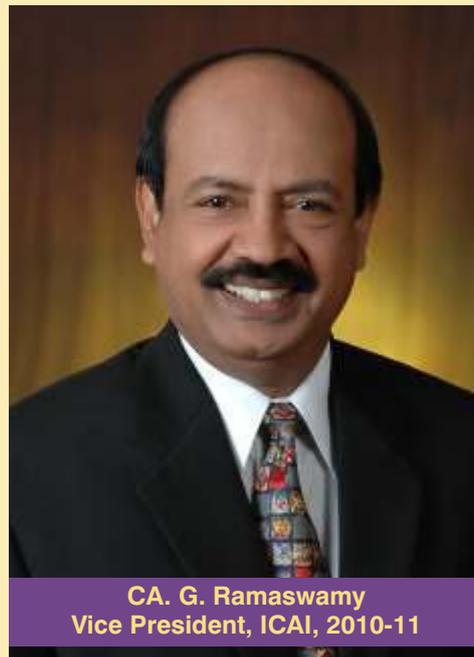
During his term 2004-07, he served as a member of the Disciplinary Committee continuously for two years. He was the Chairman of the Continuing Professional Education Committee and the Vice Chairman of the Committee on Information Technology, Committee on Corporate Governance, Fiscal Laws Committee, Committee on Commerce Education and Career Counseling. He was nominated as the Vice Chairman in the SAFA Centre of Excellence on Standards and Quality Control and as a member of the SAFA taskforce.

During his term 2007-10, he served as a member in Board of Discipline, ICAI-ICSI-ICWAI Co-ordination Committee, Committee on Ethical standards, Committee for Members in Industry, HR and Administration Committee, Committee of Direct and Indirect Taxes, Committee for SMP's, Research Committee, Representation Committee, Committee on Insurance and Pension, etc. He also served as a member in International Affairs committee, FRRB, Editorial Board, Corporate and Allied Laws Committee, etc. During these two terms, he served as a member of Professional Development Committee, Audit committee, Continuing Professional Education Committee and Auditing & Assurance Standards Board. He has also served in various sub-groups of the ICAI on Service tax, CES, DTC, CA (Amendments) Act of ICAI and worked as Chairman of Audit Committee of SIRC of ICAI.

During his tenure as the Chairman of the Southern India Regional Council (SIRC) of ICAI in 1999-2000, the SIRC bagged the best Regional Council award. He served as a member of the SIRC of the ICAI from 1994-2000. He



## PROFILE



**CA. G. Ramaswamy**  
Vice President, ICAI, 2010-11

was the Chairman of the Coimbatore Branch of the ICAI for 1988-89 and a member of the Managing Committee of the Coimbatore Branch of SIRC of ICAI for the period 1984-89.

CA. G. Ramaswamy, born in 1954, hails from Coimbatore, Tamilnadu. A practicing Chartered Accountant since 1984, he has been a fellow member of the Institute of Company Secretaries of India (ICSI) also.

He was also the member of the Body of Board of Governors of the Institute of Internal Auditors (IIA), Chennai. He has a vast experience in the field of taxation, company-law matters, audit and internal audit, and management and tax consultancy for more than two decades.

CA. G. Ramaswamy is a prolific speaker, who has addressed various national and international conferences on accounting and auditing standards, taxation, Company-Law matters, banking, etc., and also on topics related to the CA profession.

A keen golfer, he is a member of various social clubs and organisations. He has widely travelled across the globe. He has been a part of various international delegations and study tours.

**Dear All,**

Chinese philosopher Confucius had once said, 'The journey of a thousand miles begins with a single step.' As I take this first step as 58<sup>th</sup> President of the second largest accountancy body of the world, I wish to thank all those who have supported and guided me to reach this position today. I thank the members of both 20<sup>th</sup> as well as 21<sup>st</sup> Council for reposing trust and confidence in me by electing me as the Vice-President and then as the President of the ICAI during 2009-10 and 2010-11 respectively. Not to forget, I would like to thank all the members of my professional fraternity for electing me to the Central council five times consecutively. I would also like to take this opportunity to congratulate CA. G. Ramaswamy, a pragmatic professional and visionary, for getting elected as the Vice-President of the ICAI. Many congratulations to the new Council members as well, who, I am sure, will add to the vitality and vigour of the Institute and the profession.

The Institute today boasts of a very strong intellectual heritage and tradition of trust that our nation has in it, and it is my honour to be a part of this heritage and tradition. I understand the highest office, i.e., the President's office, of the Institute brings along with itself many a duty and responsibility that I can only sincerely promise to do justice to at this stage.

As I begin my journey as the President of the Institute, I would like to share with everyone that I hail from a very humble background. I cannot afford to deny the contributions of various people in my life. Our experiences and our interactions with society we live in shape our personality. They affect our growing-up process by helping us to make right decisions at the right time. I owe my ethos and accomplishments to my parents whose diligent upbringing made me what I am today. I must also express my gratitude towards my brothers and sisters, wife and children, my partners, my teachers and other colleagues. I cannot repay the debt of CA. Surjit Kumar Chopra whom I hold in high esteem as my *Guru*. I strongly believe that all of them have made very positive and significant influence in shaping my personality so far, and I would never ever forget this. In particular, I would like to acknowledge a few more names in this context: CA. S. C. Vasudeva, CA. N. V. Iyer, CA. V. Rethinam, CA. K. Sampath, CA. Girish Ahuja, CA. K. S. Mehta and CA. R. K. Batra, who have been the guiding angels in my professional space. Besides them, I adore late CA. S. P. Chhajed, CA. V. Rajaraman, CA. Y. H. Malegam, CA. T. S. Vishwanath, CA. N. P. Sarda and CA. M. M. Chitale, whom I have always admired as my role models.

Being first amongst equals, I am of the firm opinion that it is prerogative of the entire

Council to formulate its mission for the next five years that would continue to build on the foundations laid by our predecessors so that our Institute attains greater heights of professional excellence and world wide recognition. I sincerely believe that at the end of each term of the President and Vice-President, the Council must appraise their performance. I am confident that this mission can be achieved only with the organised efforts and co-operation of all stakeholders of the Institute. Some of the areas that will require focus of the Council are:

**Enhanced Students Initiatives**

There is never enough that we can do for our students, hence they will remain the focus of all our activities this year. The youth of today will be the leaders of tomorrow. However, this can only be possible by providing them the best infrastructure, educational opportunities and exposure that would hone their skills and mould them into excellent professionals.

We are confident that top-notch education is already at their command. However, the world is changing rapidly. Today, our students require many more skills than just good grades to achieve success. These intangible aspects are vital assets for a 21<sup>st</sup> century CA whether in practice or in industry. To assist us in achieving this goal, we have planned a three-pronged approach that will provide the necessary tools which will enable our students to make progress and succeed in the real competitive world.

Today, communication skills are crucial to attain success and to groom their personality. To gear up our students to face this challenge, we are planning to upgrade our course of General Management Communication Skills (GMCS), both in quantitative and qualitative manner. This well-received course has already helped thousands of our students improve their communication skills considerably. We will ensure that the revamped course will enhance our students' communication skills all the more. Further, existing modules for the IT training course will be revised to include more advanced programmes, tools and processes as per the need of hour.

As more and more students decide to embrace the profession, it behoves us to provide them an easy access to the best education possible. To fulfil these parameters, we will work on establishing a structure that covers the physical as well as the virtual aspects of education. On the physical front, we wish to put in place regular classroom teaching at all important places under the aegis of the Board of Studies. These classes will provide students complete guidance, covering each and every aspect of the course. More importantly, these will give the added

advantage of personal interaction between teachers and students wherein queries and doubts will be solved face-to-face. Taking our IT initiatives forward, we will facilitate more virtual classrooms where students can access lectures on varied subjects by renowned faculty as well as download RTPs, supplementary study material, suggested answers, etc. to prepare for exams. These initiatives will ensure that every CA student in the country has access to quality education in either the physical format or virtual format thus guaranteeing them the education they deserve.

The professionalism instilled in our students has been due to the dual factors of theory and practical education. Our students have always been good in theory. However, intelligent and efficient application of knowledge acquired is the demand of the day. What separates us professionals from others is the practical training which enhances the skills of our students and gives them experience of real life application of theoretical knowledge. We would re-orient the current examination system and correct the balance by putting more emphasis on testing the practical application skills of our students. This will ensure that our students develop into well-rounded professionals known for their all round ability.

#### **Harnessing Information Technology**

Information technology has always played a dominant role in our lives and its penetration is getting deeper and deeper. Members and students have appreciated the way in which IT has been incorporated by our Institute to further develop the professional skill sets on all fronts. We have reached a stage where we feel that the time has come to make enhanced use of IT on the administration front as well. We will like to ensure that grievance redressal system *e-samadhan* becomes more responsive and effective. We have already taken steps forward to offer better administrative services during the course of the year and put in place adequate IT infrastructure for the purpose.

#### **Expanding Infrastructure**

Infrastructure is a crucial aspect of providing the best service and facilities to our members and students. It is not simply about land, buildings or spaces but about providing means to reach out to more and more sections of society and bring them into our fold. In other words, adequate infrastructure is what keeps the CA fraternity together and gives it space to blossom. We have pledged to continue expanding on the infrastructure front and provide more facilities and services to all members and students in every city, town and district of India.



#### **Optimisation of Centres of Excellence**

Our Centres of Excellence are the pride and joy of the Institute. And now the time has come to ensure that these Centres are utilised to their maximum potential. We would like to put forward concrete plans so that these are not perceived to be just beautiful structures but temples of learning. A group has already been constituted to make necessary suggestions in this regard.

#### **Proactive Research Activities**

Our Institute plays multiple roles as educational and regulatory body established by an Act of Parliament. We firmly believe that we have the capacity to present quality research papers to the Government and industries on topics of professional and national interest. Through our research papers, we can make suggestions to the Government and various industries, highlighting ways and measures to make the optimum utilisation of scarce resources of the economy. With our objective views and insight we can observe and perceive aspects that others may not. We plan to initiate dialogue with various government agencies and departments with a view to make varied suggestions to make their working and administration smooth, efficient and cost effective. We would undertake these projects as part of our social responsibility. This will create recognition for the profession in the longer run and will also make us live up to the words 'Partner in Nation Building' as spoken for us by former Hon'ble President of India Dr. A.P.J. Abdul Kalam.

#### **Stimulating Administrative Reforms**

The life source of every organisation is its staff. They can carry the organisation on their back to great success and renown. Thus it is extremely important that the staff be motivated. While motivation is essential, what is equally essential is the assignation of the right person for the right job. It would be our goal to put the right persons at the right jobs to extract the best from them.



### Dealing with Banks Autonomy and New Professional Avenues

We have always expressed our reservations in respect of the managerial autonomy granted to Public Sector Banks (PSBs) in respect of appointment of auditors. After the issuance of the roadmap by Reserve Bank of India consequent to directive issued by the Government of India for operationalisation of managerial autonomy, we are making all out efforts to impress upon the relevant authorities to revert to the time-tested system of appointment of bank auditors prevalent upto 2005-06.

Moreover, continuing with our vigorous efforts towards exploring and making available ample opportunities for the members of the Institute in different sectors of the economy, this year we have identified railways, health and defence as major sectors to be penetrated where the professional skills of the members could be utilised in a productive and fruitful manner as true partners in nation building.

### Boosting Capacity Building Measures

In our increasingly fragmenting business world, consolidation has become a necessity. This is especially true for small and medium practitioners who are trying to cater to a clientele which is becoming more and more special services oriented. Even as CAs become more specialised in their respective fields, it has become imperative to unite with other members who are specialising in varied fields so as to offer a bouquet of services under one roof.

Considering this scenario, we have decided to encourage capacity building exercise on a continuous basis for small and medium practitioners through different approaches. One approach is through modified networking where synergies are matched for optimum results. Also on the anvil is the review of merger and de-merger schemes.

We will also strive to make our knowledge portal available to small and medium practitioners which will give access to the Institute's publications, industry specific guides, and data facilitating the audit of transfer pricing transactions at negligible cost.

### Creating Global CAs

The world is shrinking and new opportunities at the global level are being created for our members. We are following a programme that brings to light the exceptional professional qualities of the Indian CA to the world through tie-ups and networking with institutes in other countries. Through the MRAs with other international accounting institutes, we are trying to facilitate easier acquisition of membership of other institutes by our

members, thereby making services of Indian CAs available to world at large.

### Responsive Disciplinary Mechanism

As our profession and professionals grow exponentially, we are faced with increasing number of disciplinary cases. The ideal situation would be one in which there would not be a single case brought against any member of the Institute. Whereas it may never be possible to reduce the pending disciplinary cases to nil, efforts would be made to deal with the cases in time bound manner. Special attention would be paid to the cases of public interest and these will be taken up on fast track to improve the public perception about the disciplinary mechanism of the Institute.

### CABF – Strengthening the Helping Hand

The Chartered Accountant Benevolent Fund (CABF) scheme has been extending economic help and support to the ICAI members at the times of crises for years. We cannot forget the exemplary role played by our Past President late CA. P. A. Nair in promoting and strengthening this scheme. This benevolent fund has been used for providing one time financial assistance to the families of deceased members and also for providing financial support on regular basis to their families for three years which can be extended further in special cases. However, it is a matter of concern that the present corpus is not adequate and does not offer much scope for the actually required and desired assistance to the families of needy members. As such, we need to make serious efforts to increase the corpus of the benevolent fund to fulfill its true objectives. I appeal to all the members to become members of the fund and contribute generously for this noble cause. I am sure that if we come together for this noble cause, we may bring back smiles on the faces of families of our needy professional brethren.

### Strengthening Bonds

We don't exist in a vacuum. Along with us exist other sister institutes and regulatory bodies. While our focus is our Alma Mater, we should remember that our sister institutes and other regulatory bodies are also an important aspect of our professional and institutional life. Strengthening the existing bonds while also creating new ones will go a long way in uniting the Institutions together and serving the cause of the nation. The onus lies on us to take the initiative and take the first step towards forming better ties with our sister institutes.

Each and every regulatory body in India performs a vital function in the overall scheme of things. Equally important are the changes in regulations and compliance mandates that are issued by these authorities. These changes

affect us all in our professional capacity and must be tracked on a regular basis to ensure that the latest compliance mandates are brought to light as well as enforced. To ensure this we can never take our eyes off the ball. We need to make proactive efforts to build a continuous dialogue process with these bodies, nationally as well as internationally, to ensure highly professional and ethical conduct and services by our members as per requirement, in the best interest of the nation.

### The Year Ahead

We have planned and implemented programmes to enlighten professionals on IFRS so as to expand their knowledge base while also doing our best to jumpstart the process in India. We have taken it on ourselves to act as catalysts to the process of implementation of IFRS. We are sure that ICAI shall enable the government to fulfill its commitment and meet its implementation deadline.

The proposed Direct Tax Code, aimed to simplify the existing taxation mechanism, is already creating waves in the business and industry circles. We at the Institute are undertaking an in-depth analysis of each clause of the Code to recommend modifications to attain the twin objectives of canon of equity and revenue growth. Another major development on the anvil is the enactment of new Companies Bill, 2009, paving the way for the Indian corporates to become global players. Disclosure and transparency are two fundamental tenets of the Bill that will serve the interests of the society. We shall have to work in unison with the Government to achieve the avowed objectives of these proposed legislations.

As members are aware, the Government has taken the revolutionary step of implementing the GST across the country. With our expertise, we can assist the Government in this mammoth and complex task. We will suggest formats to the Government to ensure compliance with GST legislations and avoidance of revenue leakage.

### Union Budget 2010-11

Another important development of the season is the Union Budget 2010-11. It is hoped that this Budget is mainly the budget for a rebounding economy and inclusive growth with focus on checking price rise, creation of jobs, quality education, infrastructure development, rationalisation of tax regime and general relief to 'aam aadmi'. Unlike last year, when the country was still in the grip of slowdown triggered by the global crisis, there is now a sense of optimism as Indian economy has relatively rapidly returned to its growth path. The worst is behind, and with GDP recovering to 7.2 per cent, this Budget will aim at not less than 8 per

cent growth for the next fiscal, thereby strengthening the fundamentals for getting back to the pre-crisis high growth trajectory. We will be giving special coverage to the Union Budget in the next issue of the journal.

This is to share with you that on the very first day of my assuming the office, myself, the Vice-president and the Secretary, ICAI had a meeting with the Hon'ble Minister of Corporate Affairs Shri Salman Khurshid. We thanked him for the confidence reposed by the MCA in the Institute, and on behalf of the entire fraternity, assured him full support and co-operation in all efforts and initiatives of the MCA. Later on we also had a meeting with Shri R. Bandyopadhyay, Secretary, MCA and Smt. Renuka Kumar, Jt. Secretary, MCA wherein similar sentiments were reiterated. We also met Shri Jitesh Khosla, Director General, Indian Institute of Corporate Affairs and decided to organise joint programmes on the issues of professional interest.

Meanwhile, we as members should always remember that we have an active role to play and we should never behave like a passing spectator. If you have any suggestion/complaint, you may communicate through your respective representatives in the Council. Here it is significant to recall the words of our first President Shri G. P. Kapadia as under:

*"While my colleagues and I have endeavoured to solve all difficult problems and to accept constructive criticism, I cannot guarantee the satisfaction of each and every member who for one or the other reason would like to remain dissatisfied. After all, we should think in terms of an autonomous statutory body. You cannot compare the Council of such a body with the Board of Directors of a Company or Managing Agents and say that the members of the Institute are the shareholders. The shareholder is a partner in the business having stakes and having interests of a monetary character. Here the interests are of quite different character altogether; it is the status and prestige of the profession which counts and this is entirely in the hands of each and every member of the Institute."*

I believe *one and one makes eleven*, not just two. Let's be sure that *'Together we can achieve more what we want to achieve for the profession'*. I, on behalf of the Council, extend heartiest greetings for Holi. May this festival spread the colours of joy, happiness and friendship in entire professional fraternity.

With Best Wishes,  
Yours sincerely



**CA. Amarjit Chopra**  
President

New Delhi, February 22, 2010

## READERS WRITE

### Informative, Interesting Articles

I congratulate ICAI for a range of achievements made by it. It was revealing, enlightening and knowledge enhancing to go through the ICAI Achievements pages in February 2010 issue of the journal. It shows that the institute has been successfully trudging along the path of progress of the profession. 'Know Your Ethics' is another very useful feature for members. It is suggested that more such features should be started in the journal.

- CA. Sumeet Raheja

It was interesting to read the article titled 'Currency Futures: An Insight' in the journal. As per the expectation, the RBI announced the introduction of Currency Futures in other three pairs of currencies i.e. INR-Euro, INR-GBP and INR-JPY. The topic was latest and was long desired in the journal. The article is simple and easy to understand, though the concept is a complicated one. It would have been better if the author had given a table of comparison between Currency Futures and Forwards. The operational issues like execution and settlement also need to be covered.

- CA. Raja Sekhar Setty, Mumbai

The article titled 'Ways to Balance Work and Family' in January 2010 was very useful and informative. One should indeed keep a balance and time must be divided for different activities to progress on all fronts of life, including family and profession. Money is important but is not all encompassing. We should earn for a comfortable life and not for the sake of hoarding.

- CA. Mahesh Kapasi

### Women-Oriented Issue Encouraging

It was immensely joyful to read the January 2010 issue of the journal where all the articles on various topics were written by Women Chartered Accountants. The issue amply recognised the capabilities of women chartered accountants and helped in women empowerment. Congratulations to all the authors who contributed in the journal. I feel very proud to be a woman chartered accountant.

- CA. Aparna Singhi, Pune

Devoting an entire issue on the theme women empowerment was a welcome step. It is really matter of pride that our institute has identified the participation and contribution made by us. Congratulations.

- CA. Sangeeta Bordia, Udaipur

The cover page of the January, 2010 issue of the journal has come out very well with a caption "Women empowerment" and with collage of women celebrities. However, I am sorry to

note that the photograph of first woman President of India Smt. Pratibha Devi Singh Patil was missing. May be, it is due to issues of protocol.

- CA.D.Harischandra Rama, Anantapur

### Tradition of Convocations Highly Inspiring

I thank the ICAI for enthusiastically continuing with its new tradition of organizing convocations for the newly qualified Chartered Accountants. Such occasions are really inspiring and enlightening. I felt highly elated when I received my degree in one such convocation in Jaipur recently after years of unrelenting hard work. The black convocation robe & hat that I wore that day made me proud and happy like never before. When my name was announced, everything else faded away and became fuzzy. Of all the thrills and excitement I have ever experienced in my life, of all the moments I felt proud and conceited, this one conveniently topped the list. I reached the apex of my pride. The delight, the ecstasy of it all can't be expressed in words. I felt highly honoured and important as well as inspired to prove my mettle in my new professional life. The reminiscence of this day is something that newly qualified chartered accountants like me would surely want to possess throughout our lives. The experience infused me with new self confidence. I am proud to be a Chartered Accountant.

-CA. Prateek Deshlahra

### CA Should be Made Eligible for Attestation of Public Documents Too

I appreciate the overall efforts made by the Institute to enhance the prestige of CA profession. However, I would like to draw attention of the Council towards the need to get recognised the Chartered Accountants for the general attestation work of public documents at par with Gazetted Officers of Government of India. The Chartered Accountants deserve such recognition not only because of being highly trusted as backbone of Indian financial system but also because of being a member of ICAI, which has been set up by an Act of Parliament. Hence, indirectly all Chartered Accountants are part of government in connection with the maintenance of accounting and auditing profession.

- CA. Jomon C.V



## EDITOR

### For the Attention of Readers

Readers' attention is specifically invited to the fact that the views and opinions expressed or implied in *The Chartered Accountant* journal are the views and opinions of the authors only, and not those of the ICAI. The ICAI bears no responsibility of any sort whatsoever in case of any action taken by any reader based on any article published in the journal.

### Write to Editor

'Information is Power' and our ever-evolving profession needs more and more of that today than ever before. Do you have any relevant points to make, experiences to share, and views to spread among the CA fraternity? If yes, e-mail us at [board@icai.org](mailto:board@icai.org)/[nadeem@icai.org](mailto:nadeem@icai.org) or write to: The Editor, The Journal Section, ICAI, A-94/4, Sector 58, Noida (UP) - 201301



# MEMBERS OF THE TWENTY-FIRST COUNCIL & THE SECRETARY

The Institute of Chartered Accountants of India [as on 12<sup>th</sup> February, 2010]



**1<sup>st</sup> Row (L to R):** Shri Sidharth Birla, CA. Bhavna G. Doshi, Shri Prithvi Haldea, Smt. Renuka Kumar, CA. G. Ramaswamy (Vice-President), CA. Amarjit Chopra (President), Shri T. Karthikeyan (Secretary), Shri K.P. Sasidharan, Shri Anil K. Agarwal, Shri Deepak Narain.

**2<sup>nd</sup> Row (L to R):** CA. Sanjeev Krishnagopal Maheshwari, CA. Atul Bheda, CA. Jayant Gokhale, CA. Manoj Fadnis, CA. J. Venkateswarlu, CA. Sanjay Kumar Agarwal, CA. Shiwaji Bhikaji Zaware, CA. Jaydeep Narendra Shah, CA. Rajkumar S. Adukia, CA. K. Raghu.

**3<sup>rd</sup> Row (L to R):** CA. Madhukar Narayan Hiregange, CA. Ravindra Holani, CA. Sumantra Guha, CA. Nilesh Shivji Vikamsey, CA. Subodh Kumar Agrawal, CA. Vijay Kumar Garg, CA. Pankaj Inderchand Jain, CA. P. Rajendra Kumar, CA. Naveen N.D. Gupta.

**4<sup>th</sup> Row (L to R):** CA. Vinod Jain, CA. Dhinal Ashvinbhai Shah, CA. Anuj Goyal, CA. V. Murali, CA. Pankaj Tyagee, CA. M. Devaraja Reddy, CA. S. Santhanakrishnan, CA. Charanjot Singh Nanda, CA. Abhijit Bandyopadhyay.

## COUNCIL PHOTO

**Not in Picture — Shri Ashutosh Dikshit and Smt. Usha Narayanan.**



**President's Collar**

Shri T. Karthikeyan, Secretary, ICAI helps CA. Amarjit Chopra, President, ICAI, in taking over the President's Collar immediately after his election as ICAI President, while the outgoing President CA. Uttam Prakash Agarwal looks on.



**Newly-elected President and Vice President Celebrate**

CA. Girish Ahuja; Central Council member CA. Anuj Goyal and Past Presidents CA. Ved Jain and CA. Uttam Prakash Agarwal with the newly elected Vice President, CA. G. Ramaswamy, and the President, CA. Amarjit Chopra.



**Meeting with Minister of Corporate Affairs**

ICAI President CA. Amarjit Chopra meets the Minister of Corporate Affairs Shri Salmaan Khurshid along with ICAI Vice-President CA. G. Ramaswamy, immediately after assuming office on February 12, 2010.



**Meeting with Secretary, MCA**

CA. Amarjit Chopra, President, ICAI, CA. G. Ramaswamy, Vice President, ICAI, Shri T. Karthikeyan, Secretary, ICAI, meet Shri R. Bandyopadhyay, Secretary, Ministry of Corporate Affairs on February 17, 2010.



**Inaugurating the Tirupati Branch**

President, CA. Amarjit Chopra, and the Vice President, CA. G. Ramaswamy along with the Central Council members CA. M. Devaraja Reddy, CA. J. Venkateswarlu and CA. P. Rajendra Kumar inaugurating the Tirupati branch of SIRC of ICAI on February 16, 2010.

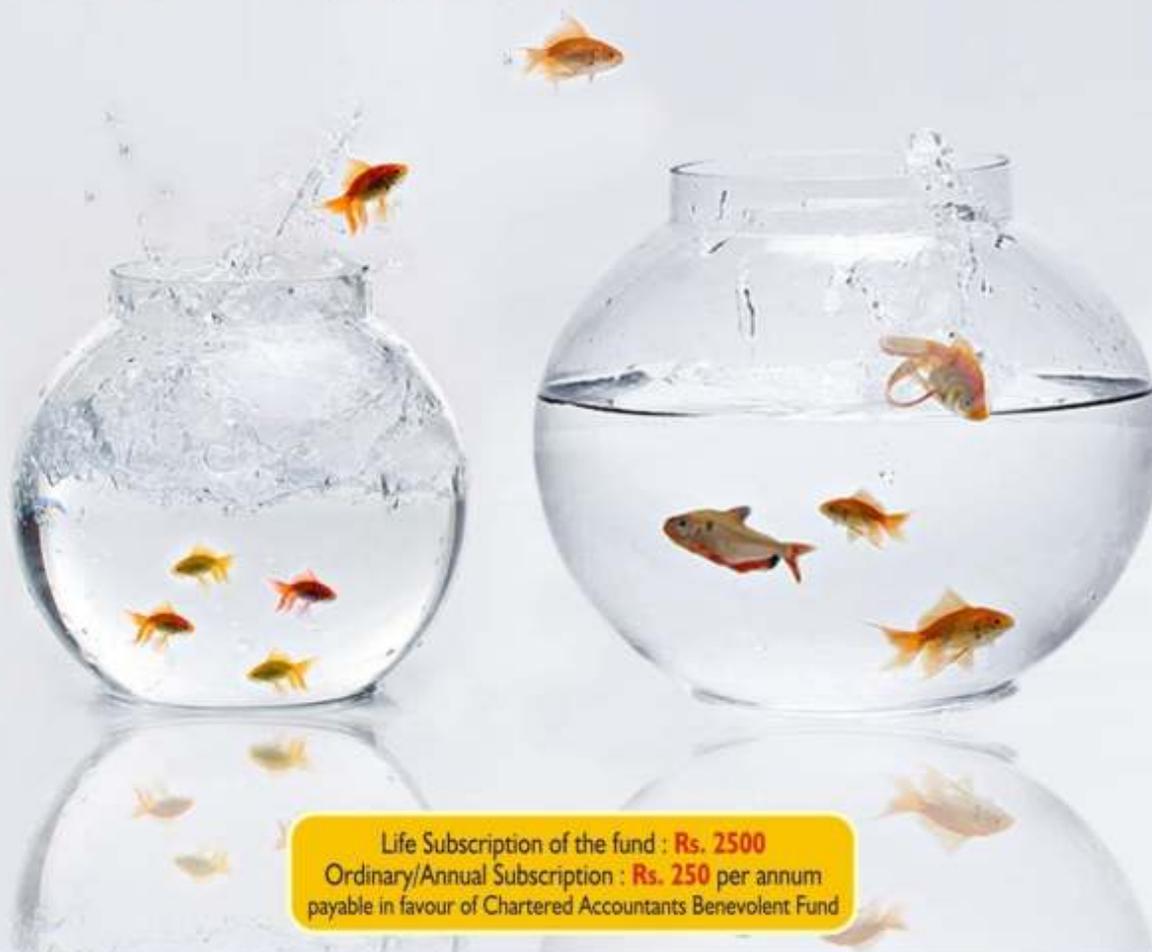


**NIRC**

President of the ICAI CA. Amarjit Chopra with Shri Ajay Maken, Hon'ble Minister of State for Home Affairs at the Annual Prize Distribution of the NIRC at Vigyan Bhawan on February 22, 2010.

# WANT TO BE A CONTRIBUTOR FOR A NOBLE CAUSE? **CONTRIBUTE TO CABF**

A Fund set up by the members, for the members



Life Subscription of the fund : **Rs. 2500**  
Ordinary/Annual Subscription : **Rs. 250** per annum  
payable in favour of Chartered Accountants Benevolent Fund

ICAI invites its members to become life members of CABF, registered under the Societies Registration Act 1860. The Fund was set up by the members of the Institute for the members of the Institute to provide financial assistance for maintenance/ education/ medical needs of its members and their families in distress.

From 1st February 2009 to till date, CABF provided financial assistance to 178 members/their families. More than 94,500 members of the Institute have already joined as life members. Members may contribute voluntarily any sum over and above life contribution for the noble and pious cause. Contributions are eligible for tax exemption under section 80-G of Income Tax Act.



Chartered Accountants Benevolent Fund  
(Registered under the Societies Registration Act, 1860)  
**C/o The Institute of Chartered Accountants of India**  
ICAI Bhawan, Indraprastha Marg, New Delhi - 110002

Visit us at the link funds/award in members area on website [www.icaai.org](http://www.icaai.org), e-mail : [cabf@icaai.in](mailto:cabf@icaai.in)



## 60<sup>th</sup> Annual Function of the Institute – A Report

The 60<sup>th</sup> Annual Function of the Institute was held on February 11, 2010, at the Vigyan Bhawan in New Delhi. Prof. Saugata Roy, Hon'ble Minister of State for Urban Development and Poverty Alleviation, Government of India, was the Chief Guest, and Shri Rajkumar Dhoot, Hon'ble Member of Parliament (Rajya Sabha) and Shri S.S.N. Moorthy, Chairman of the Central Board of Direct Taxes (CBDT), Ministry of Finance, Government of India, graced the function as the Guests of Honour.

At the outset, CA. Amarjit Chopra, Vice-President-in-office at the time, welcoming the Chief Guest and the Guests of Honour, thanked them for sparing their precious time to grace the 60<sup>th</sup> Annual Function of the Institute. He also welcomed, among others, the functionaries of the Institute at various levels – past and present, members, other dignitaries, and prize winners. Thereafter, CA. Chopra, stating that the Function was a kind of self-retrospection as to what all have been achieved during the year that has gone by, briefly apprised the Chief Guest and the Guests of

Honour with the activities of the Institute. He then stated that the Institute, with the strength of members and students as more than one lakh sixty thousand and six lakh twenty five thousand respectively – has been very actively engaged in the convergence process of the Indian Accounting Standards with the International Financial Reporting Standards (IFRSs). It is a matter of pride that the Institute was comparable with the best in the world and that its members were recognised globally. It is remarkable to note that in the last three years, mutual recognition arrangements (MRAs) have been entered into by the Institute, inter alia, with the Institute of Chartered Accountants in England and Wales (ICAEW) and Institute of Chartered Accountants in Australia and that many more such MRAs were in the pipeline. He added that the continuing professional education emphasis laid by the Institute was reckoned as equally best, and that the Institute's disciplinary mechanism was well built.

CA. Uttam Prakash Agarwal, President-in-office at the time, during his Presidential address, at the outset, congratulated all the members and students

for the Recognition of Excellence Award conferred on the Institute by Smt. Pratibha Devisingh Patil, Hon'ble President of India, at the India Corporate Week observed by the Ministry of Corporate Affairs during December 14-21, 2009. Briefly highlighting the recent initiatives of the Institute, CA. Agarwal said that the thrust has been on 3 Is, i.e., Information Technology, Infrastructure and Increased International Recognition. With rapid advancements on the front of information technology both locally and globally, Parivartan project has been undertaken by the Institute with a view to building



### Lighting the Lamp of Knowledge and Growth

Shri Rajkumar Dhoot, Hon'ble MP Rajya Sabha, Prof. Saugata Roy, Minister of State for Urban Development and Poverty Alleviation, CA. Amarjit Chopra, Vice-President-in-office at the time, Shri S.S.N. Moorthy, Chairman, and CA. Uttam Prakash Agarwal, President-in-office at the time.



**Addressing (L to R) are :** Prof. Saugata Roy, Chief Guest, Shri Rajkumar Dhoot, and Shri S.S.N. Moorthy, Guests of Honour, at the 60<sup>th</sup> Annual Function.

increased IT interface between the Institute on the one hand and the members, students and others, on the other hand, so that fuller potential of IT facilities was exploited and consequently not only services were availed at a faster pace but also at much less cost. It is in this context that portals have been launched to provide for, amongst others, e-learning so that the members could take advantage of the same from the comfort of their office or home. Similarly, members have been facilitated to undertake their continuing professional education through the webcast channel.

On the infrastructure front, the main aim has been that services to the Institute's members and students be made available to them as close to their place of office/stay as possible. With this background, branches of the Institute that are spread across the country have been encouraged to have their own suitable premises and consequently, a good number of branches have started constructing their own buildings.

Coming to the issue of increased international recognitions, CA. Uttam Prakash Agarwal, stated that while the process had been sped up by his predecessor-in-office CA. Ved Jain, the same was taken forward by him with every possible effort, and MRAs, as pointed out briefly by CA. Amarjit Chopra in his welcome address, entered into with some of the renowned sister-institutions abroad. Besides, a bilateral agreement with the Certified General Accountants Association of Canada, that was founded in 1908, has been signed and many such agreements are in the advanced stage of completion. Arising out of the initiatives undertaken, heads of various international professional bodies, including those in America, Australia, and Canada, participated in the Institute's International Conference organised in July, 2009 at Agra. This only proved that the education and training system of the ICAI was recognised as

comparable to the best at global level. CA. Uttam Prakash Agarwal added that at the national level also, the Institute entered into a Memorandum of Understanding (MoU) with the Universities at Coimbatore and at Nashik providing for exemption in certain papers of the MBA syllabi of those universities to the Chartered Accountants desirous of pursuing the MBA. Similarly, the Institute entered into an MoU with the postal authorities to convert their accounts from single entry to double entry through the ICAI-ARF.

With regard to the interactions with various government and regulatory authorities, CA. Agarwal stated that it was a matter of satisfaction that the members of the Institute enjoyed commendable standing with such authorities, including the RBI, the CBDT, the SEBI, the IRDA, and the C&AG, and they were often recalled to share their expertise and experience on matters of common interest. While concluding his Presidential address, CA. Agarwal thanked the Chief Guest and the Guests of Honour for their benign presence and congratulated the winners of various awards/prizes.

Shri Rajkumar Dhoot, Hon'ble Member of Parliament (Rajya Sabha), Guest of Honour, sharing his thoughts, recalled that he once himself desired to join the profession of Chartered Accountants but that as the destiny would have it, he could not do that. But, he felt honoured to be in the midst of the august gathering of Chartered Accountants and being a part of the 60<sup>th</sup> Annual Function of the Institute, and he thanked the Institute for the same.

The Guest of Honour observed that the Chartered Accountants played a very important role in the affairs of any entity and in the well-being of its shareholders

and stakeholders alike. For the reasons of rigorous training and high degree of competence, the advice rendered or attestation functions discharged by the Chartered Accountants were accepted and acted upon beyond any possible doubt by all sections of society, including the government authorities. However, in the rapidly-changing economic environment, the role of the Chartered Accountants has assumed greater significance with regard to transparency, accountability and fairness in the affairs as also the ethos of corporate governance by the entities. He added that the central theme of corporate governance was aimed at maximum benefit for all the segments of society, including shareholders, stakeholders, employees, revenue to the government and service providers. On a personal note, he stated that as an industrialist he placed greatest reliance on the Chartered Accountants who help him in the affairs of his Group of Companies.

While congratulating the Institute and its members for stature earned over the years, Shri Dhoot quoted the father of our nation Mahatma Gandhi, who had counseled the pioneer and legendary industrialist Dr. G.D. Birla that an industrialist must run the company not as the owner of the company but as the trustee of the company, and in that sense, the Guest of Honour hoped that the Chartered Accountants would continue to perform and strengthen their role as trustees of the public. Further, congratulating the President of the Institute for the dynamism displayed by him, particularly with regard to the initiatives undertaken in the development of infrastructure and establishment of Centres of Excellence, Shri Dhoot invited the

Institute to set up its Centre of Excellence in Aurangabad as well. For the purpose, the Guest of Honour, offered all his assistance in procuring the land in Aurangabad at concessional rate. He also donated to the Institute a sum of Rs. 25 lakhs from his Parliamentary Fund. He added that Shri Murali Deora, Hon'ble Minister for Petroleum & Natural Gas, Government of India, has asked him to convey to the Institute his willingness to assist in the matter, and that Shri Deora has also offered his contribution of Rs. 10 lakhs.

Shri S.S.N. Moorthy, the Chairman of Central Board of Direct Taxes, the other Guest of Honour, thanked the Institute for the opportunity extended to him to share some of his thoughts about the profession of Chartered Accountants. He also observed that the CA profession was at a critical stage of transformation for the reason that corporations and society as a whole were at the threshold of new company law, direct taxes code, GST, and new accounting standards as well as challenges thrown up by the globalised economy, and that these would change the face of professional services to a large extent. Therefore, it was inevitable that one may have to unlearn and relearn. While expressing his satisfaction that the Institute has already geared up to face the challenges, the Guest of Honour, welcomed continued contributions and suggestions from the Institute.

While referring to the recent economic melt-down faced world over, Shri Moorthy commended the finance managers in India whose contribution was



CA. Uttam Prakash Agarwal, President-in-office at the time presents memento to Prof. Saugata Roy, Minister of State for Urban Development and Poverty Alleviation, as Shri T. Karthikeyan, Secretary, ICAI, Shri S.S.N. Moorthy, Chairman CBDT, and CA. Amarjit Chopra, Vice-President-in-office at the time look on.

significant in the well-being of the corporations because of which the brunt of melt-down felt by India was the least and the Indian economy continued to grow albeit at somewhat lesser rate in comparison with growth in the previous years. The Guest of Honour added that the contribution made by the Chartered Accountants in their various capacities including finance managers, as also their capacity to withstand the pressures or temptations, in strengthening of corporate governance greatly helped Indian economy not to be as much affected by the melt-down as faced by economies of the western countries.

Referring to the trust reposed on the Chartered Accountants by various regulators, Shri Moorthy stated that the attest function performed by the Chartered Accountants was generally accepted as fair, complete and correct. He, however, added that like in any other institution, there could be a percentage or two of human aberration, and seen from that point of view, Shri Moorthy urged that care be taken by the Institute, which was a very competent professional body having a glorious history of its own, so that the well earned trust remained unshaken. The Guest of Honour then emphasised the importance of the process of continuing education as that would help in improved corporate governance through the impending new company law, direct taxes code, and GST. In his conclusion Shri Moorthy congratulated the students who had come out with flying colours in the Institute's examinations and thus bagged the awards/prizes.

Chief Guest Prof. Saugata Roy, Hon'ble Minister of State, Ministry of Urban Development, observed that the presentation of awards was an interesting part of any function. He further stated that he was thrilled to find prize winners from small townships and from remote areas of our nation, and thus first congratulated them as also the other awardees for their excellent performance in the discharge of their onerous duties.

Sharing his thoughts, the Chief Guest Prof. Roy observed that the range of services rendered by the Chartered Accountants has undergone a total change. He recalled that when he was young, he used to ask his friends pursuing Chartered Accountancy course what they studied and he was told they were learning auditing. When he asked his friends after they became Chartered Accountants what they did, their response

was that they advised clients on how to plan their taxes. Sometime later, when he again asked them the same, those Chartered Accountants responded that they were then advising on corporate management. Prof. Roy stated that the Chartered Accountants were equipped to render such a wide range of services because of the very high standard of Institute's system of training and examinations, and that was the reason why Indian Chartered Accountants have gained the confidence of one and all. He exhorted the members of the Institute to keep up their high standards built up by the profession over the years. Regarding the reach of the profession, the Chief Guest expressed his happiness that the Institute has its branches throughout the length and breadth of the country, including smaller towns such as Siliguri and that the Chartered Accountants were in best position to promote financial inclusion of the rural poor too, who did not have access to finances from formal sources like micro and other innovative measures.

Prof. Roy stated that the Satyam episode some time ago had, besides leaving a bad taste, affected a large number of shareholders and stakeholders giving a jolt to the credibility of the whole system including corporate governance. Sharing his concerns, he mentioned that the recent scams and corporate failures have shaken investors' confidence and the whole world was watching intently the steps being taken by various statutory authorities in this regard. There was a growing demand from various quarters to have stringent laws and regulations in India like Sarbanes-Oxley Act. While the local regulations are generally stringent in comparison with international standards, considering the kind of Enron and Satyam like corporate failures that the world has faced in the recent past, these regulations needed re-examination. Further, improvement in areas like remuneration of Audit Committee members, their training and the extent to which they could be held liable in case of default would enable them to discharge their responsibilities more effectively and efficiently. Thus there was an urgent need to examine the entire gamut of issues pertaining to the auditor-company relationship and related issues. Expressing his satisfaction that the Institute had already made efforts in that direction, the Chief Guest observed that the profession needed to work even harder to restore the credibility of the systems in the corporate entities, as good governance is a natural corollary of accounting practices which are transparent, consistent, complete

and provide reliable set of information on the most optimal use of public resources to the stakeholders. He added that he was of the firm belief that the Institute, through its march towards financial transparency, will have many more moments of glory.

The Chief Guest mentioned that he was happy that the Government was also now emphasising on the mandatory resort to double entry accrual based accounting system in the municipalities which is one of the important reforms under the Jawaharlal Nehru National Urban Renewal Mission (JNNURM). With this background, before any money was released to municipalities or corporations under the above Mission, adoption of double entry accrual based accounting system by them was insisted upon. The said Mission is a major driver for attracting investment in urban infrastructure for financially sustainable urban and local bodies, but that practices adopted by a few unscrupulous professionals was a dark area and the same needed to be plugged and suo motu action be taken against such elements. Action so taken should also be widely publicised as the same would benefit not only the chartered accountants fraternity but the society as a whole, besides acting as deterrence and enhancing the image of and the confidence in the profession. While concluding, the Chief Guest extended his best wishes to all the award winners at the Annual Function, particularly the young students who were embarking on a career and expected their contributions in bringing in innovative ideas and suggestions for the betterment of the profession.

Shri T. Karthikeyan, the Secretary of the ICAI, first of all, thanked Prof. Saugata Roy, Chief Guest, Shri Rajkumar Dhoot, Guest of Honour and Shri S.S.N. Moorthy, Guest of Honour, for making it possible, despite their hectic schedule and prior commitments, to be with the fraternity of Chartered Accountants on the occasion of the 60<sup>th</sup> Annual Function. He also thanked Shri Rajkumar Dhoot for the generous contribution announced by him. He added that the profession shortly hoped an appropriate announcement from Shri S.S.N. Moorthy, Hon'ble Chairman of the CBDT as well in recognition of the role and services being rendered by the members of the Institute for the national exchequer. Signifying the importance of the occasion, he stated that the day was not only for taking stock of the tasks that have been accomplished during the past twelve months, but also for formulating and evolving strategy for the coming

years, especially in the context that the 20<sup>th</sup> Council was completing its three-year term that day and next day the new Council, i.e. 21<sup>st</sup>, would be taking charge. The day was also special for the reason that the 21<sup>st</sup> Council would not only address the unfinished agenda of the 20<sup>th</sup> Council but would also draw the roadmap for the coming years.

Referring to the addresses by the Chief Guest and the Guests of Honour, Shri T. Karthikeyan thanked them all for their words of wisdom and recognition of the competence, role and performance of the members of the Institute. With regard to the observations made by them on certain aspects, the Secretary mentioned that the ethical standards of the Institute were very sound, robust, and perhaps most stringent when compared globally and such standards stood the test of time over the last sixty years. Adding that every year, a number of disciplinary cases are dealt with, the Secretary, however, confessed that the Institute was hesitant in publicising the action taken against the erring members. As for the Satyam episode, the Secretary stated that it was no secret now that the said episode was more an issue of corporate governance than the accounting weakness. With regard to the challenges, Shri Karthikeyan assured the Chief Guest and the Guests of Honour that the training provided by the Institute to its students as also the continuous professional education to its members were such that it enabled them to face any kind of challenges and to deliver to the satisfaction of all concerned. While again thanking them for their thought-provoking addresses, the Secretary assured the Chief Guest and the Guests of Honour that The Institute of Chartered Accountants of India would not be found wanting in meeting and fulfilling the expectations of the Government, regulators, industry and the public at large, and that its commitment would continue to work towards gaining the public confidence and serving the interests of the public and being an effective partner in nation building.

While concluding, Shri T. Karthikeyan proposed a hearty vote of thanks to the Chief Guest and the Guests of Honour, the dignitaries and all others participants.

A large number of members, students and other invitees were part of the 60<sup>th</sup> Annual Function.

AWARDEES AT THE 60<sup>th</sup> ANNUAL FUNCTION

## Chartered Accountants Final Examination – November, 2008



**1<sup>st</sup> Rank**  
Ms.  
**Surbhi Aggarwal**

**(Roll No: 30501) Gurgaon**

1. Certificate of Merit – First Rank
2. The G. P. Kapadia – First President Gold Medal for the best candidate of the examination
3. The Ramachandra Singhi Prize for the best candidate of the examination
4. Smt. Sarojini Sitaram Memorial Silver Medal for the best lady candidate of the Year
5. The R. Sivabhogam Prize for the best lady candidate of the examination
6. The T. C. Minakshisundram Prize for the best lady Candidate of the examination



**2<sup>nd</sup> Rank**  
Mr. Naishal  
**Pratikumar Shah**

**(Roll No: 00118), Ahmedabad**

1. Certificate of Merit - Second Rank
2. The R. K. Khanna – Past President Gold Medal for the second best candidate of the examination
3. Shri N. M. Shah Silver Medal with gold centering for the candidate securing the second highest marks, i.e. overall Second Rank
4. The Sir Shapoorji Billimoria Prize for the Best Papers on Advance Accounting – (Paper-1) and Management Accounting & Financial Analysis (Paper-2)
5. The Shailesh Kapadia Silver medal with Gold Centering for the best candidate among the second best candidate of the Year.
6. Shri D. Rangaswamy Memorial Prize for the best paper on Advanced Accounting (Paper-1).



**3<sup>rd</sup> Rank**  
Mr. Niket  
**Rameshbhai Thacker**

**(Roll No: 00380) Adipur (Kutch)**

1. Certificate of Merit – Third Rank
2. Shri N. Rangachary Silver Medal for the candidate securing the third highest marks, i.e. overall Third Rank.
3. The A. F. Ferguson Prize for the best paper on Advanced Auditing (Paper 3) Jointly with Shri Shreyans Hitendra Mehta and Shri Shreyansh Mohanlal Jain.
4. The R. Venkatesan Memorial Prize for the best paper on Advanced Auditing (Paper 3) jointly with Shri Shreyans Hitendra Mehta and Shri Shreyansh Mohanlal Jain.

## Chartered Accountants Final Examination – June, 2009



**1<sup>st</sup> Rank**  
Mr. Giriraj Ajmera

**(Roll No: 25862) Bhilwara**

1. Certificate of Merit – First Rank
2. The G. P. Kapadia – First President Gold Medal for the best candidate of the examination
3. The Ramchandra Singhi Prize for the best candidate of the examination



**2<sup>nd</sup> Rank**  
Mr. Akram Jamal

**(Roll No: 23700) Kolkata**

1. Certificate of Merit – Second Rank
2. The R. K. Khanna – Past President Gold Medal for the second best candidate of the examination
3. Shri N. M. Shah Silver Medal with gold centering for the candidate securing the second highest marks, i.e. overall Second Rank



**3<sup>rd</sup> Rank**  
Mr. Vikesh Mundhra

**(Roll No: 09755) Surat**

1. Certificate of Merit – Third Rank jointly with Ms. Ruchika Katyal
2. Shri N. Rangachary Silver Medal for securing the third highest marks, i.e. overall Third Rank jointly with Ms. Ruchika Katyal



**3<sup>rd</sup> Rank**  
Ms. Ruchika Katyal

**(Roll No: 35796) Rohtak**

1. Certificate of Merit – Third Rank jointly with Mr. Vikesh Mundhra
2. Shri N. Rangachary Silver Medal for securing the third highest marks, i.e. overall Third Rank jointly with Mr. Vikesh Mundhra.
3. The T. C. Minakshisundram Prize for the best lady candidate of the examination
4. The R. Sivabhogam Prize for the best lady candidate of the examination
5. The Late L. T. Colonel Ambuj Nath Bose Memorial Prize for the best paper on Management Accounting and Financial Analysis (Paper-2) jointly with Shri Deepak K.

We congratulate all the awardees who received their medals and merit certificates from the august hands of the Chief Guest Prof. Saugata Roy, Hon'ble Minister of State, Ministry of Urban Development & Poverty Alleviation, Government of India. In addition, awards and merit certificates were also given to the rank holders of CPT, PE-II and Professional Competence examinations of the Institute.

# Know Your Ethics

(...Continued from the *February 2010* issue)

## Ethical Issues in Question-Answer Form

**Q.** Whether communication with previous auditor is necessary in case of appointment as statutory auditor by nationalised and other banks?

**A.** Yes, Clause (8) of Part I of the First Schedule to the CA Act is equally applicable in case of nationalised and other banks and also to Government agencies.

**Q.** Whether communication by the Incoming auditor is mandatory with the previous auditor in respect of various audit assignments, like the concurrent audit, revenue audit, tax audit and special audits etc.?

**A.** Yes, the requirement for communicating with the previous auditor would apply to all types of audits viz., statutory audit, tax audit, internal audit, concurrent audit or any other kind of audit. The Council has laid down detailed guidelines in this regard and the same are appearing at pages 166-168 of Code of Ethics, 2009.

**Q.** Whether a Chartered Accountant will be deemed to be guilty of professional misconduct if he accepts his appointment as an auditor immediately after intimating his appointment over the phone to the previous auditor?

**A.** Yes, the member would be held guilty of professional misconduct for the following reasons:

- (a) That he had failed to communicate with the retiring auditor in writing; and
- (b) That he did not wait for a reasonable length of time for a reply to be received from him.

**Q.** Whether a Chartered Accountant can accept an appointment as auditor of a company without first ascertaining from it whether the requirement of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with?

**A.** No, as per Clause (9) of Part I of the First Schedule to the CA Act, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with. In this regard, the Council has laid down detailed guidelines that are appearing at pages 188-196 of Code of Ethics, 2009.

**Q.** Whether a statutory auditor can be appointed in the adjourned meeting in place of existing statutory auditor where no special notice for removal or replacement of the retiring auditor is received at the time of the original meeting?

**A.** No, if any annual general meeting is adjourned without appointing an auditor, no special notice for removal or replacement of the retiring auditor received after the adjournment can be taken note of and acted upon by the company, since in terms of Section 190(1) of the Companies Act, 1956, special notice should be given to the Company at least fourteen clear days before the meeting in which the subject matter of the notice is to be

considered, the meeting contemplated in Section 190(1) undoubtedly is the original meeting.

**Q.** Whether a Chartered Accountant or a firm of Chartered Accountants can charge or offer to charge professional fees based on a percentage of turnover?

**A.** No, in terms of Clause (10) of Part I of First Schedule to the CA Act it is not permitted to a Chartered Accountant or a firm of Chartered Accountants to charge fees on a percentage of turnover, except in the circumstances provided under Regulation 192 of the CA Regulations. Regulation 192 reads as under:

### "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 or 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."

**Q.** Whether a Chartered Accountant in practice can engage in any business or occupation other than the profession of Chartered Accountancy?

**A.** No, in terms of Clause (11) of Part I of First Schedule to the CA Act, in general, a Chartered Accountant in practice is not permitted to engage in any business or occupation other than the profession of Chartered Accountancy.

However, there are following exceptions to it:-

1. A Chartered Accountant can be a director of a company (not being a managing director or a whole time director), unless he or any of his partners is interested in such company as an auditor.
2. A Chartered Accountant in practice may engage in any business or occupation with the permission granted in accordance with a resolution of the Council.

Appendix (9) of CA Regulations contains the above Resolution under two heads (A) Permission granted generally (B) Permission to be granted specifically. (please refer pages 345-349 of the Code of Ethics, 2009).

**Q.** Whether a Chartered Accountant in practice is entitled to accept teaching assignment?

**A.** Yes, a Chartered Accountant in practice is allowed to accept teaching assignment in university, affiliated colleges, educational institution, coaching organisation, private tutorship under the specific permission of the Council, provided the direct teaching hours devoted to such activities taken together do not exceed 25 hours a week.

## LEGAL DECISIONS<sup>1</sup>

### DIRECT TAXES



#### Income-tax Act

#### Section 2(42A) of the Income-tax Act, 1961 – Short-term Capital Asset

Where (i) company offered shareholder partly convertible debentures on rights basis, but he renounced his right for consideration in favour of someone else and (ii) shareholder suffered diminution in value of original equity shares, net loss suffered by assessee would be short-term capital loss

Navin Jindal vs. Asstt. CIT, 11<sup>th</sup> January 2010 (SC)

The right to subscribe for additional offer of shares/debentures on Rights basis, on the strength of existing shareholding in the Company, comes into existence when the Company decides to come out with the Rights Offer. Prior to that, such right, though embedded in the original shareholding, remains inchoate. The same crystallizes only when the Rights Offer is announced by the Company. Therefore, in order to determine the nature of the gains/loss on renunciation of right to subscribe for additional shares/debentures, the crucial date is the date on which such right to subscribe for additional shares/debentures comes into existence and the date of transfer [renunciation] of such right. The said right to subscribe for additional shares/debentures is a distinct, independent and separate right, capable of being transferred independently of the existing shareholding, on the strength of

which such Rights are offered.

For the purposes of Section 48, one must keep in mind an important principle, namely, that chargeability and computation has to go hand in hand. In other words, computation is an integral part of chargeability under the Act. It is for this reason, it was to be opined that the right to subscribe for additional offer of shares/ debentures comes into existence only when the Company decides to come out with the Rights Offer. It is only when that event takes place that diminution in the value of the original shares held by the assessee takes place. One has to give weightage to the diminution in the value of the original shares which takes place when the Company decides to come out with the Rights Offer. For determining whether the gains/loss of renunciation of right to subscribe is a short-term or long-term gains/loss, the crucial date is the date on which such right to subscribe for additional shares/debentures comes into existence and the date of renunciation [transfer] of such right.

Where (i) company offered shareholder partly convertible debentures on rights basis, but he renounced his right for consideration in favour of someone else and (ii) shareholder suffered diminution in value of original equity shares, net loss suffered by assessee would be short-term capital loss.

#### Section 44BB of the Income-tax Act, 1961 – Non-residents, Business of Exploration Mineral Oils etc.

Where applicant, a non-resident provides geophysical services to international oil and gas industry, for which applicant conducts seismic surveys and provides on-shore seismic data acquisition and other

associated services such as processing and interpretation of such data to global and oil companies, applicant will be liable to tax in India and its income has to be computed in terms of Section 44BB.

Geofizyka Torun Sp.zo.o., In re, 7<sup>th</sup> December, 2009 (AAR)

The applicant, a non-resident, provides geophysical services to international oil and gas industry. The applicant conducts seismic surveys and provides on-shore seismic data acquisition and other associated services such as processing and interpretation of such data to global and oil companies. The question arose about taxability and computation of its income.

The Authority for Advance Rulings held that to attract the first part of section 44BB, the non-resident must be (a) engaged in the business of providing services or facilities; (b) such provision of services/facilities must be 'in connection with' the prospecting for or extraction or production of mineral oils. Both these ingredients are present in relation to the activities undertaken by the applicant in India.

Whether applicant was engaged in the business of providing services or facilities?

The applicant is engaged in the business of providing services (technical services) to the oil sector industries. It is not some sporadic or isolated activities that are being carried on by the applicant. The applicant claims to have many clients in India and it has been engaged in the said activities since many years. The applicant has been filing returns and is being assessed to tax from 2002-03 onwards and even for the year 2009-10 return has been filed. It is an

<sup>1</sup> Edited by Mr. Susanta K. Sahu, Sr. Asst. Secretary, ICAI. Readers are invited to send their comments on the selection of cases and their utility at [ebboard@icai.org](mailto:ebboard@icai.org). For the convenience of readers full text of these cases have been hosted on the website of the institute at the link: [www.icai.org/post.html?post\\_id=967&c\\_id=59](http://www.icai.org/post.html?post_id=967&c_id=59)

undisputed and undeniable fact that the activities or operations of the applicant in India have the characteristics of 'business' and the applicant is engaged in the said business in India and other countries.

Whether the applicant provides services in connection with the prospecting for or extraction of mineral oils?

There is hardly any room for doubt. The expression 'in connection with' is important and has to be construed to have expansive meaning.

Keeping the exposition of the phrase "in connection with", it is crystal clear that the services offered by the applicant is in connection with the prospecting for or extraction of mineral oils, which business is carried on by the applicant's employers viz. those in the business of oil and gas production. The real, intimate and proximate nexus between the services performed by the applicant in India and the prospecting for or extraction of mineral oils (which expression includes petroleum and natural gas) is very much present in the instant case.

The seismic survey and data acquisition, as stated by the applicant, is a prelude and a very critical component of the oil and gas exploration activity. Without seismic data acquisition and interpretation, it is impracticable to carry out the activity of prospecting which is a step in aid to exploration. It would be difficult to locate hydro-carbons without conducting seismic survey and the utilization of data emerging from it. The services of the nature undertaken by the applicant have a direct and definite bearing on the prospecting/exploration activities and they are integral to the said activities undertaken by petroleum and gas enterprises. It can by no means be said that the geophysical services have nothing to do or only remotely connected with the exploration of mineral oils. In fact, there is no serious dispute on this aspect.

#### Meaning of term 'services'

There is no compelling reason to assign a narrow and restricted meaning to the expression 'services' and confine it to services other than technical, consultancy or managerial services. In the absence of any words of limitation or exclusion, the word 'services' shall be understood in its plain and ordinary sense. If the Legislature wanted to give a restricted meaning to the expression 'services' in order to take the technical services out of the purview of Section 44BB, explicit words to that effect would have been deployed, especially in view of the fact that Section 44BB is a later provision. On the other hand, the contextual setting and the company in which the expression 'services' is found is suggestive of inference that far from excluding technical/consultancy services, they were also intended to be brought within the ambit of Section 44BB. The word 'services' followed by an expansive phrase 'in connection with' are relatable to Prospecting for and exploration of mineral oil. That means, all services associated with Prospecting for and exploration activities are brought within the scope and reach of Section 44BB. Another category of assessee governed by Section 44BB are those supplying plant and machinery on hire. Both these two categories of assessee covered by Section 44BB engage themselves in core activities pertaining to prospecting and exploration of oil and gas and the Parliament thought it fit to accord a special treatment to the income derived by these two categories of non-residents in India.

Whether in absence of any mining or like projects, and by providing mere technical services, applicant is covered by explanation to section 9(1)(vii)?

CBDT Circular No. 202 dated 5-7-1976 [105 ITR ST 25] stated that the consideration from such projects has been excluded from the definition (of FTS) on the ground that such activities virtually amount to carrying

on business in India for which considerable expenditure will have to be incurred by a non-resident and accordingly, it will not be fair to tax such consideration in the hands of a foreign company on gross basis or to restrict the expenditure incurred for earning the same to 20 per cent of the gross amount as provided in the new Section 44D. The same rationale should logically apply to the non-residents engaged in the business of providing services for the specified projects in India. Be that as it may, there was no occasion for the CBDT to consider in 1976 the implications of the exclusion clause vis-à-vis the specified service providers because Section 44BB was not there at that time.

After Section 44BB was introduced Circular (Instruction No. 1862) was issued by the CBDT on 22<sup>nd</sup> October, 1990. This circular has been relied upon by the Income-tax Appellate Tribunal in a number of cases in order to reach the conclusion that Section 44BB governs the cases in which the services (including technical services) are rendered in relation to the prospecting for or exploration of oil. This also makes clear that the expressions "mining project" or "like project" occurring in Explanation 2 to Section 9(1)(vii) of the I.T. Act would cover rendering of services like imparting training and carrying out drilling operations for exploration or exploitation of oil and natural gas; and Profits arising from the business specified in Section 44BB may also fall within the ambit of fees for technical services chargeable under Section 9(1)(vii).

Section 44BB, which was inserted into the Act w.e.f. 1<sup>st</sup> April, 2004 is a special, specific and exclusive provision dealing with the computation of profits of the non-resident assessee engaged in the business of providing services in connection with or supplying plant and machinery on hire to be used "in the prospecting for, or extraction or production of mineral oils". It is in the company of

three other sections (which we have referred to earlier as 44B series) specially providing for computation of profits of the non-residents/foreign companies engaged in the specified types of business. True, profits arising from the business specified in Section 44BB may also fall within the ambit of fees for technical services chargeable under Section 9(1)(vii).

Income received by a non-resident businessman for the technical services provided in relation to prospecting and extraction of mineral oil will be wholly governed by Section 44BB for purposes of computation.

As between the competing provisions, namely 9(1)(vii) read with Sections 44DA and 44BB, Section 44BB being a more specific provision, that provision should prevail for the purposes of computation. Section 44DA, it may be recalled, provides for method of computation of income by way of f.t.s received by a non-resident or a foreign company carrying on business through a PE in India. If the non-resident is engaged in the business of providing services in connection with the prospecting etc. of mineral oils, the computation provisions relating to f.t.s will have to yield to Section 44BB. It may be noticed that in a case of business governed by Section 44BB, normally, the enterprise concerned would be having a PE in India. It is difficult to envisage a situation of a person being engaged in providing services or facilities in connection with prospecting and extraction of mineral oils not having a fixed place of business from where the operations are carried on. Thus, the existence of PE is a common feature both in 44DA as well as 44BB, though there is an explicit reference to PE under Section 44DA. Thus, rendering of technical services through PE may be a common feature of both the Sections, i.e., 44BB and 44DA, though in the case of Section 44DA, it is explicitly mentioned. But, what is important is the nature of business and it is that factor which serves as an indicator to apply one of the two sections. If the business is of the

specific nature envisaged by 44BB, the computation provision therein would prevail over the computation provision in Section 44DA. In other words, the income received by a non-resident businessman for the technical services provided in relation to prospecting and extraction of mineral oil, will be wholly governed by Section 44BB for the purposes of computation. If all the services that are in the nature of technical services within the meaning of Explanation 2 to Section 9(1)(vii) are to be computed in accordance with 44DA, very little purpose will be served by incorporating a special provision in 44BB for computing the profits in relation to the services connected with exploration and extraction of mineral oils. The provision will then operate in a very limited field.

The income has to be computed in terms of Section 44BB.

#### **Section 45, read with section 48 of the Income-tax Act, 1961 – Capital Gains – Chargeable as**

**Where under a plan of reorganisation, US Company transferred shares in Indian subsidiaries to US subsidiaries/companies established as part of organisation; transfer of shares is not chargeable to tax as capital gains under Income-tax Act, 1961**

**Dana Corporation, In re, 30<sup>th</sup> November 2009 (AAR)**

Section 45 charges the profits or gains arising from the transfer of a capital asset to income tax. Section 48 provides for “Mode of computation” of capital gains. It is settled law that Section 45 must be read with Section 48 and if the computation provision cannot be given effect to for any reason, the charge under Section 45 fails.

The profit or gain envisaged by Section 45 is not something which remains ambivalent or indefinite or indeterminable. The profit or gain or the full value of the consideration, cannot be arrived at on notional or hypothetical basis. The profit or gain to the transferor must be a distinctly and clearly identifiable component of the transaction. The consideration for

the transfer of shares in terms of money or money's worth is not something which can be implied or assumed. No profit or gain in the form of consideration for transfer can be inferred by a process of deeming or on presumptive basis. There must be a causal nexus between the transfer of capital asset and the profit or gain accruing to or received by the assessee.

The applicant Dana Corporation (DC) was a US company and underwent bankruptcy proceedings. DHC and DCLLC are the companies established as part of reorganization of DC. DHC is 100% holding company of DCLLC. Dana merged with DCLLC. Thus, DCLLC being successor to DC, has to bear the tax liability of DC. DC owned shares in US and Indian subsidiaries. The shares held by DC in two US subsidiary companies (Dana WTC and Dana Global) were transferred to DHC. The said two companies, however, continued to hold the shares of the Indian subsidiary companies. In effect, DC which was holding shares in Indian companies directly, post restructuring, held them indirectly through the US subsidiary companies. Later, when DC transferred shares of the US companies Dana WTC and Dana Global to DHC, it effectively transferred its indirect control over the Indian companies to DHC. Subsequently, there was also transfer of shares of Indian companies by DC to Dana WTC and Dana Global. The question arose as to whether transfer of shares would be chargeable to tax as capital gains.

The Authority for Advance Rulings held that:

The two questions that need to be answered to resolve the issue are: (i) did any profit or gain within the meaning of Section 45 arise to the transferor (the applicant) on account of transferring the shares in the Indian companies? and (ii) was any amount received by or accrued to the applicant by way of consideration resulting from the transfer of capital asset (shares)? In other words, whether the ingredient of full value of

consideration as contemplated in section 48 is present in the instant case?

Both these questions can only be answered in the negative. In *Sunil Siddharthbhai vs. CIT* [1985] 156 ITR 509, the Supreme Court upheld the principle that the profits or gains under the Income-tax Act must be understood in the sense of real profits or gains, on the basis of ordinary commercial principles on which the actual profits are computed.

The liabilities of the applicant which DHC took over as a part of reorganization cannot be legitimately treated as consideration nor can it adopted as a measure of consideration for the transfer of shares. The profit arising from the transfer or the consideration for the transfer cannot be equated to a part of the liabilities assumed by DHC. True, the consideration can also flow from a third party like DHC. But the question is whether DHC, in taking over the liabilities together with the assets of DC (the applicant) can be said to have passed on consideration for the transfer of shares? Did the parties intend that a specified extent of liabilities taken over by DHC should be treated as the consideration for the transfer of shares? The answer is in negative. One cannot find consideration for the transfer by means of conjectures and assumptions. When the entire assets and liabilities of DC (applicant) have been taken over by DHC, which is neither transferor nor transferee, in order to reorganize the business, it is difficult to envisage that a proportion of liabilities constitutes consideration for transfer, notwithstanding the fact that such consideration was never defined nor identified. No commercial or accountancy principle supports such inference. It is difficult if not impossible to predicate that a given part of the liabilities represents the consideration for transfer and such consideration has been passed on to the transferor (applicant). None can keep out of consideration the entire purpose and substratum of reorgani-

sation as a part of bankruptcy proceedings, nor can import artificial notions of consideration. Thus, viewed from any angle, the takeover of the liabilities by DHC under the reorganisation plan cannot be treated as the consideration for the transfer of the Indian company shares by the applicant. Nor can it be said that the applicant had, by transferring such shares to its subsidiaries, derived a profit or gain. The fact that the applicant put forward the reorganization plan in the overall interests of its business and that there is certain business advantage to the applicant has no bearing on the point whether any consideration has in fact been received or accrued on the transfer of shares. In fact, such benefit or advantage in the larger sense is incapable of being computed in monetary terms as representing the valuable consideration for transfer. The recital in the Shares Transfer Agreement that the transfer was effected without consideration, therefore, reflects the correct position.

Shares may have been notionally valued for the purpose of preparing the financial statements or to facilitate the reorganization process. For that reason, it cannot be reasonably said that the book value or the market value of the shares really represents the consideration for the transfer or the profit arising from the transfer.

Therefore, the facts on record judged in the light of reorganization plan lead to a reasonable inference that there was no consideration for the transfer or at any rate the consideration is indeterminable and therefore the charging provision Section 45 becomes inapplicable. Therefore, the transfer of shares of the three Indian companies by the applicant DC to US Dana WTC and Dana Global is not chargeable to tax as capital gains under the Income-tax Act, 1961.

**Section 80-IA of the Income-tax**

**Act, 1961 - Deduction - Profits and gains from industrial undertakings engaged in infrastructure developments, etc.**

**Process of commercial duplication by which a blank CD is transformed into software loaded marketable CD constitutes "manufacture or processing of goods"**

**CIT vs. Oracle Software India Ltd, 13<sup>th</sup> January 2010 (SC)**

Assessee imported Master Media of the software from Oracle Corporation, USA which was duplicated on blank discs, packed and sold in the market. The question, arose process by which a blank Compact Disc (CD) is transformed into software loaded marketable disc constitutes "manufacture or processing of goods".

The Supreme Court held that from the details of Oracle Applications, it could be seen that the software on the Master Media was an application software. It was not an operating software. It was not a system software. It could be categorised into Product Line Applications, Application Solutions and Industry Applications. Such commercial duplication process involves four steps. For the said process of commercial duplication, one requires Master Media, fully operational computer, CD Blaster Machine (a commercial device used for replication from Master Media), blank/ unrecorded Compact Disc also known as recordable media and printing software/ labels. The Master Media is subjected to a validation and checking process by software engineers by installing and rechecking the integrity of the Master Media with the help of the software installed in the fully operational computer. After such validation and checking of the Master Media, the same is inserted in a machine which is called as the CD Blaster and a virtual image of the software in the Master Media is thereafter created in its internal storage device. This virtual image is utilized to replicate the software on the recordable media.

What is virtual image? It is an

image that is stored in computer memory but it is too large to be shown on the screen. Therefore, scrolling and panning are used to bring the unseen portions of the image into view. According to the same Dictionary, burning is a process involved in writing of a data electronically into a programmable read only memory (PROM) chip by using a special programming device known as a PROM programmer, PROM blower, or PROM blaster.

Commercial duplication cannot be compared to home duplication. Complex technical nuances are required to be kept in mind while deciding issues of the present nature. The term "manufacture" implies a change, but, every change is not a manufacture, despite the fact that every change in an article is the result of a treatment of labour and manipulation. However, this test of manufacture needs to be seen in the context of the above process. If an operation/process renders a commodity or article fit for use for which it is otherwise not fit, the operation/process falls within the meaning of the word "manufacture". When an assessee undertakes an operation which renders a blank CD fit for use for which it was otherwise not fit, the blank CD is an input. By the duplicating process undertaken by the assessee, the recordable media which is unfit for any specific use gets converted into the programme which is embedded in the Master Media and, thus, blank CD gets converted into recorded CD by the afore-stated intricate process. The duplicating process changes the basic character of a blank CD, dedicating it to a specific use. Without such processing, blank CDs would be unfit for their intended purpose. Therefore, processing of blank CDs, dedicating them to a specific use, constitutes a manufacture in terms of Section 80IA(12)(b) read with section 33B.

Even if software on the Master Media and software on pre-recorded media is same, there is manufacture even though end product is not

different from original product.

Firstly, the input in this case was blank disc. Secondly, the test applied may not be relevant in the context of computer technology. In the case of *Tata Consultancy Services vs. State of Andhra Pradesh*, 137 STC 620 (SC) it was held that a software programme may consist of commands which enable the computer to perform a designated task. The copyright in the programme may remain with the originator of the programme. But, the moment copies are made and marketed, they become goods. It was held that even an intellectual property, once put on to a media, whether it will be in the form of computer discs or cassettes and marketed, it becomes goods.

The intelligence/logic (contents) of a software programme do not change. They remain the same, be it in the original or in the copy.

To say, that content of the original and the copy are the same and, therefore, there is manufacture would not be a correct proposition.

The American Courts in such cases have evolved a new test to determine as to what constitutes manufacture. They have laid down the test which states that if a process renders a commodity or article fit for use which otherwise is not fit, the operation falls within the letter and spirit of manufacture. [See *United States vs. International Paint Co.* reported in 35 C.C.P.A. 87, C.A.D. 76].

Marketed copies are goods and if they are goods then the process by which they become goods would certainly fall within the ambit of Section 80 IA(12)(b), read with Section 33B because an industrial undertaking has been defined in Section 33B to cover manufacture or processing of goods.

**Section 80-IA of the Income-tax Act, 1961 - Deduction - Profits and gains from industrial undertakings engaged in infrastructure developments, etc.**

**Twisting and texturising of partially oriented yarn (POY) amounts to**

**'manufacture'**

**CIT vs. Emptee Poly-Yarn Pvt. Ltd, 20<sup>th</sup> January 2010 (SC)**

POY is a semi-finished yarn not capable of being put in warp or weft, it can only be used for making a texturized yarn, which, in turn, can be used in the manufacture of fabric. In other words, POY cannot be used directly to manufacture fabric. According to the expert, crimps, bulkiness etc. are introduced by a process, called as thermo mechanical process, into POY which converts POY into a texturised yarn. If one examines this thermo mechanical process in detail, it becomes clear that texturising and twisting of yarn constitutes 'manufacture' in the context of conversion of POY into texturized yarn.

In the case of *CIT vs. Oracle Software India Ltd.*, reported in 2010 (1) SCALE 425, it was held that if an operation/process renders a commodity or article fit for use for which it is otherwise not fit, the operation/process falls within the meaning of the word "manufacture".

POY simpliciter is not fit for being used in the manufacture of a fabric. It becomes usable only after it undergoes the operation/process which is called as thermo mechanical process which converts POY into texturised yarn, which, in turn, is used for the manufacture of fabric.

The definition of the word 'manufacture' is made explicit by Finance Act No. 2/2009 which states that 'manufacture' shall, *inter alia*, mean a change in bringing into existence of a new and distinct object or article or thing with a different chemical composition or integral structure. The thermo mechanical process involved also bring about a structural change in the yarn itself, which is one of the important tests to be seen while judging whether the process is manufacture or not. The structure, the character, the use and the name of the product are indicia to be taken into account while deciding the question whether the process is a manufacture or not.

It is the thermo mechanical process embedded in twisting and texturing when applied to a partially oriented yarn which makes the process a manufacture.

Note: It should not be understood that per se twisting and texturing would constitute 'manufacture' in every case. In each case, one has to examine the process undertaken by the assessee.

**Section 115JB of the Income-tax Act, 1961 – Special Provision for payment of tax by certain companies**

To work out book profit as per provisions of Section 115JB, claim of deduction under Section 80HHC is to be excluded [Assessment Year 2004-05]

**DCIT vs. Glenmark Laboratories Ltd, 9<sup>th</sup> November 2009 (MUM-ITAT)**

Under the normal provisions of the Income-tax Act, the assessee had no taxable income. Hence, the

Assessing Officer determined the book profit under section 115JB. The case of the assessee was that deduction under Section 80HHC is allowable even while computing the book profit under Section 115JB. The Assessing Officer rejected the contention of the assessee. However, the Commissioner (Appeals) accepted the claim of the assessee that deduction under Section 80HHC has to be computed after taking 'book profit' as total income of the assessee.

The Tribunal held that the view taken by the Commissioner (Appeals) was justified.

**Section 147 of the Income-tax Act, 1961 – Income escaping Assessment**

After 1<sup>st</sup> April, 1989, Assessing Officer has power to re-open assessment, provided there is "tangible material" to come to the conclusion that there is escapement of income from

assessment; reasons must have a live link with formation of belief

**CIT vs. Kelvinator of India Limited, 18<sup>th</sup> January 2010 (SC)**

On going through the changes, made to section 147, it may be found that, prior to Direct Tax Laws (Amendment) Act, 1987, re-opening could be done under above two conditions and fulfillment of the said conditions alone conferred jurisdiction on the Assessing Officer to make a back assessment, but in section 147 of the Act [with effect from 1<sup>st</sup> April, 1989], they are given a go-by and only one condition has remained, viz., that where the Assessing Officer has reason to believe that income has escaped assessment, confers jurisdiction to re-open the assessment. Therefore, post- 1<sup>st</sup> April, 1989, power to re-open is much wider. However, one needs to give a schematic interpretation to the words "reason to believe" failing

## LEGAL UPDATE

Legal Decisions

which, Section 147 would give arbitrary powers to the Assessing Officer to re-open assessments on the basis of "mere change of opinion", which cannot be *per se* reason to re-open. It is to be kept in mind the conceptual difference between power to review and power to re-assess. The Assessing Officer has no power to review; he has the power to re-assess. But re-assessment has to be based on fulfillment of certain pre-condition and if the concept of "change of opinion" is removed, then, in the garb of re-opening the assessment, review would take place. One must treat the concept of "change of opinion" as an in-built test to check abuse of power by the Assessing Officer. Hence, after 1<sup>st</sup> April, 1989, Assessing Officer has power to re-open, provided there is "tangible material" to come to the conclusion that there is escapement of income from assessment. Reasons must have a live link with the formation of the belief.

This view gets support from the changes made to Section 147. Under the Direct Tax Laws (Amendment) Act, 1987, the Parliament not only deleted the words "reason to believe" but also inserted the word "opinion" in Section 147 of the Act. However, on receipt of representations from the Companies against omission of the words "reason to believe", the Parliament re-introduced the said expression and deleted the word "opinion" on the ground that it would vest arbitrary powers in the Assessing Officer. [Vide Circular No.549 dated 31-10-1989].

### OTHER ACTS

#### Advocate Act

#### Section 29 read with Section 33 of



**the Advocates Act, 1961 – Advocates to be the only recognised class of persons entitled to**

#### practice law

**Expressions 'to practise profession of law' in Section 29 is wide enough to cover persons practising in litigious matters as well as persons practising in non litigious matters and, therefore, to practise in non litigious matters in India, foreign law firms are bound to follow provisions contained in Advocate Act**

**Lawyers Collective vs. Bar Council of India and Others, 16<sup>th</sup> December 2009 (BOM)**

From the statements of Objects & Reasons for enacting the Advocate Act, 1961, it may be seen that the 1961 Act is intended to apply to (i) persons practising the profession of law in any part of the country and (ii) persons practising the profession of law in any Court including the Supreme Court. Thus, it is evident that the 1961 Act is intended to apply not only to the persons practising before the Courts but it is also intended to apply to persons who are practising in non litigious matters outside the Court.

Apart from the above, Section 29 specifically provides that from the appointed day, there shall be only one class of persons entitled to practise the profession of law, namely Advocates.

Section 33 is a prohibitory section in the sense that it debar any person from appearing before any Court or authority unless he is enrolled as an advocate under the 1961 Act. The bar contained in Section 33 Act has nothing to do with the persons entitled to be enrolled as advocates under Section 29. A person enrolled as an advocate under Section 29 Act, may or may not be desirous of appearing before the Courts. He may be interested in practising only in non litigious matters. Therefore, the bar under Section 33 from appearing in any Court (except when permitted by Court under Section 32 of the 1961 Act or any other Act) unless enrolled as an advocate does not bar a person from being enrolled as an advocate under section 29 for practising the profession of law in non litigious matters.

The Apex Court in the case of *Ex-Capt. Harish Uppal vs. Union of India* (2003) 2 SCC 45 has held that the right to practise is the genus of which the right to appear and conduct cases in the Court may be a specie. Therefore, the fact that section 33 provides that advocates alone are entitled to practise before any Court / authority, it cannot be inferred that the 1961 Act applies only to persons practising in litigious matters and would not apply to person practising in non litigious matters.

The fact that Section 35 provides imprisonment for persons illegally practising in Courts and before other authorities, it cannot be said that the 1961 Act does not contain provisions to deal with the persons found guilty of misconduct while practising in non litigious matters. Once it is held that the persons entitled to practise the profession of law under the 1961 Act covers the persons practising the profession of law in litigious matters as well as nonlitigious matters, then, the penal provisions contained in section 35 would apply not only to persons practising in litigious matter, but would also apply to persons practising the profession of law in nonlitigious matters.

When the Parliament has enacted the 1961 Act to regulate the persons practising the profession of law, it would not be correct to hold that the 1961 Act is restricted to the persons practising in litigious matters and that the said Act does not apply to persons practising in non litigious matters. There is no reason to hold that in India the practise in non litigious matters is unregulated.

If the argument that the 1961 Act is restricted to the persons practising the profession of law in litigious matters is accepted, then an advocate found guilty of misconduct in performing his duties while practising in nonlitigious matters cannot be punished under the 1961 Act. Similarly, where an advocate who is debarred for professional misconduct can merrily carry on the practise in

nonlitigious matters on the ground that the 1961 Act is not applicable to the persons practising the profession of law in non litigious matters. Such an argument which defeats the object of the 1961 Act cannot be accepted.

It may be noted that Rule 6(1) in Chapter III Part VI of the Bar Council of India Rules framed under section 49(1) (ah) of the 1961 Act provides that an advocate whose name has been removed by an order of the Supreme Court or a High Court or the Bar Council as the case may be, shall not be entitled to practise the profession of law either before the Court and authorities mentioned under Section 30, or in chambers, or otherwise. The above rule clearly shows that the chamber practise, namely, practise in non litigious matters is also within the purview of the 1961 Act.

**FERA**  
**Section 29 of the Foreign Exchange Regulation Act, 1973 – Restrictions on establishment of place of business in India**



**RBI cannot grant permission to Foreign Law firms to establish liaison offices in India under Section 29 to carry on practice of nonlitigious matters without being enrolled as Advocates under Advocates Act, 1961**

**Lawyers Collective vs. Bar Council of India and Others, 16 December 2009 (BOM)**

Section 29 provides that without the permission of RBI, no person resident outside India or a person who is not a citizen of India but is resident in India or a Company which is not incorporated in India shall establish in India a branch office or other place of business, for carrying any activity of a trading, commercial or industrial nature. Foreign law firms engaged in practicing the profession of law in the foreign countries cannot be said to be engaged in industrial, commercial and trading activities. The liaison activities by foreign law firm in India being activities relating to the profession of law, no permission could be granted to the foreign law firms under Section 29.



## CIRCULARS/NOTIFICATIONS

### DIRECT TAXES

#### I. Circulars

##### 1. Circular No. 2/2010, dated 29-1-2010

The CBDT, has, vide its Circular No. 2/2010 dated 29/01/10 clarified that any installment of advance tax paid in respect of fringe benefit for A.Y. 2010-11 shall be treated as Advance Tax paid by assessee concerned for A.Y. 2010-11. The assessee can adjust such sum against its advance tax obligation in respect of income for A.Y. 2010-11 or in case of loss to claim such payment as refund as advance tax paid in A.Y. 2010-11.

##### 2. Circular F.NO. 275/192/2009-IT (B), dated 9-2-2010

The CBDT has issued a clarification regarding the deduction under Section 80 CCD for contribution made under pension scheme in the light of Circular No-1/2010 dated 11<sup>th</sup> January 2010 issued on the subject of Deduction of Tax at Source etc.

It is clarified that in accordance with the provisions of Section 80CCD, deduction in respect of contribution made by an individual in the previous year to his account under a pension scheme notified, is allowed in computation of his total income

- (a) in the case of an employee, ten per cent of his salary in the previous year; and
- (b) in any other case, ten per cent of his gross total income in the previous year.

It is further clarified that where the Central Government or any other employer makes any contribution to the account of employee for the pension scheme, the assessee shall also be allowed a deduction in the computation of his total income of the whole of the amount contributed by the Central Government or any other employer as does not exceed 10% of his salary in the previous year.

Salary for the purpose of above section 80CCD includes dearness allowance if the terms of employment so provide, but excludes all other allowances and perquisites.

It is further clarified that aggregate limit of deduction under this section 80CCD along with Sections 80C, 80CCC shall not in any case exceed Rs. One lakh. The complete text of the above-mentioned circulars can be downloaded from [www.incometaxindia.gov.in](http://www.incometaxindia.gov.in)

(Matter on Direct Taxes has been contributed by the Direct Taxes Committee of the ICAI)



### INDIRECT TAXES

#### A. EXCISE

##### 1. Circular No. 912/02/2010-CX dated 22.01.2010

Area based exemption is available to the units in the specified areas in the North-East region, Jammu & Kashmir, Himachal Pradesh and Uttarakhand under different notifications. The exemption is applicable to the new industrial units set up after the specified date and also to the existing units which have undertaken substantial expansion by way of increase in installed capacity by not less than 25%.

In this regards, this circular has been issued to clarify that only when the substantial expansion of the installed capacity of the specified goods is undertaken, then only the benefit of notification would be applicable.

The complete text of the above-mentioned circular can be downloaded from <http://www.cbec.gov.in/excise/cx-circulars/cx-circulars-10/9122k10cx.htm>

#### B. SERVICE TAX

1. Circular No. 120/2010-ST dated 19.01.2010 has been issued to clarify the following points in relation to problem faced by exporters in availing refund of excess credit:

- i) Use of different phrases in rules and notification;
- ii) One-to-one co-relation between inputs and outputs and scrutiny of voluminous record;
- iii) Quarterly refund claims; and
- iv) Incomplete invoices.

The complete text of the above-mentioned circular can be downloaded from <http://www.servicetax.gov.in/st-circularng.htm>

(Matter on Indirect Taxes has been contributed by the Indirect Taxes Committee of the ICAI)



#### FEMA

##### 1. Exchange Earner's Foreign Currency (EEFC) Account – Clarification RBI/2009-10/275 A.P. (DIR Series) Circular No.22 dated December 29, 2009

Based on various queries received by RBI regarding eligibility of person to open, hold and maintain EEFC account, it has been clarified by RBI that all categories of foreign exchange earner's are allowed to open EEFC account and credit up



to 100% of their foreign exchange earnings, according to Para 1(A) of the schedule.

##### 2. Establishment of Branch Office (BO)/Liaison Office (LO) in India by Foreign Entities - Eligibility Criteria and Procedural Guidelines

##### RBI/2009-10/278 A. P. (DIR Series) Circular No.23 dated December 30, 2009

(Ref – Notification No. 22/2000-RB dated May 3, 2000 on Foreign Exchange Management (Establishment in India of Branch or Office or other place of business) Regulations, 2000)

Applications from foreign companies for establishing BO / LOs in India are considered by RBI under (1) **Reserve Bank Route** – For carrying of business activity where 100% FDI is permissible under automatic route, and (2) **Government Route** – For carrying of business activity where 100% FDI is not permissible under automatic route. RBI has published the eligibility criteria and procedural guidelines for establishing BO & LO in India.

Banks and Insurance companies would be governed by old guidelines only and NO RBI approval would be required to establish branch or unit in SEZ for undertaking manufacturing and service activities, subject to compliance with the conditions specified in Notification No. FEMA 102/2003-RB dated October 3, 2003 read with A.P. (DIR Series) Circular No.58 dated January 16, 2004.

Detailed eligible criteria for establishing BO/LO in India and documents for the same is given in Annexure A of circular. Scope of activity permitted to carry on in India by BO/LO and other procedural guidelines for functioning in India is given in Annexure B of Circular.

The same can be seen on the RBI website <http://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=5441&Mode=0>

##### Certain other regulations framed by RBI for BO & LO are as follows:

1. Application to establish BO/LO in India should be forwarded through AD in form FCN to RBI along with prescribed documents.
2. AD should carry on due diligence for background of applicant antecedents of the promoter, nature and location of activity, sources of funds, etc. and also ensure compliance with the KYC norms before forwarding the application to RBI.
3. A Unique Identification Number (UIN) would be allotted by RBI to New as well as existing BO & LO to bring uniformity.

4. BO/ LO has to obtain PAN from income tax department in India and report the same in the annual activity certificate.

### **3. Establishment of Branch Office (BO)/Liaison Office (LO) in India by Foreign Entities - Delegation of Powers**

**RBI/2009-10/279 A. P. (DIR Series) Circular No.24 dated December 30, 2009**

With a view to liberalising the existing procedure in respect of BO/LOs, it has been decided to delegate certain powers to the designated AD Category - I banks (AD), as under:

1. **Submission of Annual Activity Certificate** – With effect from February 1, 2010, BO/ LO are required to submit Annual Activity Certificate from their auditor to AD on or before 30<sup>th</sup> April and copy to the Directorate General of Income Tax (International Taxation). AD should ensure that BO/LO are carrying on activity permitted by RBI.
2. **Extension of validity period of Liaison Offices** – AD has been given authority to grant extension of 3 years to LO, if annual activity certificate is submitted by LO and Bank account of LO is maintained with AD as per the terms & condition stipulated in approval by RBI.
3. **Closure of BO/LO** – With effect from February 1, 2010, the work related to closure of Branch / Liaison Offices shall be handled by AD. The closure formalities shall be dealt in accordance with Regulation 6 (1) (iii) of Notification No. FEMA 13/2000-RB dated May 3, 2000 on Foreign Exchange Management (Remittance of Assets) Regulations 2000.

Following documents are required to be obtained by AD while considering the closure of the BO/ LO and permitting the remittance of winding up proceeds:

- A) Copy of the Reserve Bank's permission/ approval from the sectoral regulator(s) for establishing the BO/LO.
- B) Auditor's certificate-
  - a. confirming that all liabilities in India including arrears of gratuity and other benefits to employees, etc., of the Office have been either fully met or adequately provided for;
  - b. indicating the manner in which the remittable amount has been arrived at and supported by a statement of assets and liabilities of the applicant, and indicating the manner of disposal of assets;
  - c. confirming that no income accruing from sources outside India (including proceeds of exports) has remained unrepatriated to India.
- C) No-objection / Tax Clearance Certificate from Income-Tax authority for the remittance/s.
- D) Confirmation from the applicant/parent company that no legal proceedings in any Court in India are pending and there is no legal impediment to the remittance.
- E) A report from the Registrar of Companies regarding compliance with the provisions of the Companies Act, 1956, in case of winding up of the Office in India.
- F) Any other document/s, specified by the Reserve Bank while granting approval may be obtained and verified.

AD should make sure that annual activity certificate is filed by BO/LO. Closure of BO/ LO should be reported by the designated AD Category - I bank to RBI.

### **4. Purchase of Immovable Property in India by Persons of Indian Origin (PIOs) – Amendment of the definition**

**RBI/2009-10/286 A. P. (DIR Series) Circular No.25 dated January 13, 2010**

(Ref - Regulation 2 clause (c) of Notification No. FEMA 21/2000-RB dated May 3, 2000 viz. Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India), Regulations, 2000)

According to above referred notification 'a Person of Indian Origin' means an individual (not being a citizen of Pakistan or Bangladesh or Sri Lanka or Afghanistan or China or Iran or Nepal or Bhutan) who (i) at any time, held an Indian Passport or (ii) who or either of whose father or whose grandfather was a citizen of India



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by virtue of the Constitution of India or the Citizenship Act, 1955 (57 of 1955).

Government of India, has amended definition of 'PIO' vide G.S.R.813 (E) in the Gazette of India dated November 12, 2009 as under-

Accordingly, 'a Person of Indian Origin' means an individual (not being a citizen of Pakistan or Bangladesh or Sri Lanka or Afghanistan or China or Iran or Nepal or Bhutan) who (i) at any time, held an Indian Passport or (ii) who or either of whose father or mother or whose grandfather or grandmother was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955 (57 of 1955).

### 5. Remittance of Salary - Relaxation

**RBI/2009-10/288 A. P. (DIR Series) Circular No.26 dated January 14, 2010**

(Ref - A. P. (DIR Series) Circular No. 17 dated September 20, 2003 and sub-regulation 8 of Regulation 7 of Notification No. FEMA 10/2000-RB dated May 3, 2000 viz. Foreign Exchange Management (Foreign Currency Account by a person resident in India) Regulation, 2000)

This Circular Relaxes the terms of remittance of salary outside India as under-

- i. A citizen of a foreign state, resident in India, being an employee of a foreign company or A citizen of India, employed by a foreign company outside India on deputation to the office/branch/subsidiary/joint venture in India of such foreign company may open, hold and maintain a foreign currency account with a bank outside India and **receive the whole salary payable** to him for the services rendered in India of such foreign company, by credit to such account, **provided that income-tax chargeable under the Income-tax Act, 1961 is paid on the entire salary as accrued in India.**
- ii. A citizen of a foreign state, resident in India, being in employment with a company incorporated in India may open, hold and maintain a foreign currency account with a bank outside India and **remit the whole salary received in India in Indian Rupees**, to such account, for the services rendered to the Indian company, **provided that income-tax chargeable under the Income-tax Act, 1961 is paid on the entire salary accrued in India.**

### 6. Guidelines on trading of Currency Futures in Recognised Stock Exchanges

**RBI/2009-10/290 A. P. (DIR Series) Circular No.27 dated January 19, 2010**

(Ref - A.P.(DIR Series) Circular No. 05 dated August 06, 2008 Currency Futures (Reserve Bank) Directions, 2008 [Notification No. FED.1/ DG (SG)-2008 dated August 6, 2008])

Currently, persons resident in India are permitted only to trade in US Dollar (USD)-Indian Rupee (INR) currency futures contracts in recognized stock exchanges.

In order to facilitate direct hedging of currency risk in other currency pairs as well, Reserve Bank of India has permitted the recognized stock exchanges to offer currency futures contracts in the currency pairs of Euro-INR, Japanese Yen (JPY)-INR and Pound Sterling (GBP)-INR, in addition to the USD-INR contracts, with immediate effect.

### 7. External Commercial Borrowings (ECB) Policy

**RBI/2009-10/292 A. P. (DIR Series) Circular No.28 dated January 25, 2010**

(Ref - A.P. (DIR Series) Circular No. 5 dated August 1, 2005, A.P. (DIR Series) Circular No. 26 dated October 22, 2008 and para 2 (v) of A.P. (DIR Series) Circular No.19 dated December 9, 2009)

As per the extant policy, eligible borrowers in the telecommunication sector are permitted to avail of ECB for the purpose of payment for spectrum allocation, under the automatic route.

This circular has given a one-time relaxation in the end-use conditions of the ECB policy. Accordingly, the payment for spectrum allocation may initially be met out of Rupee resources by the successful bidders, to be refinanced with a long-term ECB, under the **approval route**, subject to the following conditions:

- i. The ECB should be raised within 12 months from the date of payment of the final installment to the Government;
- ii. The designated AD - Category I bank should monitor the end-use of funds;
- iii. Banks in India will not be permitted to provide any form of guarantees; and
- iv. All other conditions of ECB, such as eligible borrower, recognized lender, all-in-cost, average maturity, etc, should be complied with.

Eligible borrowers in the telecommunications sector intending to fund the payment for Spectrum allocation directly out of the proceeds of the ECBs may continue to avail of the ECBs under the automatic route as per the extant policy.

### 8. Export and Import of Currency

**RBI/2009-10/297 A. P. (DIR Series) Circular No.30 dated February 01, 2010**

(Ref - clauses (a) and (c) of sub-regulation (1) of Regulation 3 of Foreign Exchange Management (Export and Import of Currency) Regulations, 2000, notified vide Notification No. FEMA 6 /RB-2000 dated May 3, 2000)

According to above referred regulation, any person resident in India was allowed to take outside India or having gone out of India on a temporary visit, may bring into India (other than to

and from Nepal and Bhutan) currency notes (of Government of India and Reserve Bank of India) up to an amount not exceeding Rs.5,000 per person.

As part of providing greater flexibility to the resident individuals travelling abroad, the existing limits, mentioned above, has been enhanced to Rs. 7,500 per person by Government of India.

### 9. External Commercial Borrowings (ECB) Policy - Liberalisation

**RBI/2009-10/311 A. P. (DIR Series) Circular No.33 dated February 09, 2010**

As per the extant ECB procedures, any changes in the terms and conditions of the ECB after obtaining the Loan Registration Number (LRN) from the Department of Statistics and Information Management (DSIM), Reserve Bank, require the prior approval of the Reserve Bank.

As a measure of simplification of the existing procedures, RBI has delegated powers to the designated AD category-I banks to approve the following requests from the ECB borrowers, subject to specified conditions:

#### a) Changes / modifications in the drawdown/repayment schedule

Designated AD Category - I banks may approve changes / modifications in the drawdown / repayment schedule of the ECBs already availed, both under the approval and the automatic routes, subject to the condition that the average maturity period, as declared while obtaining the LRN, is maintained.

#### b) Changes in the currency of borrowing

Designated AD Category - I banks may allow changes in the currency of borrowing desired by the borrower company, in respect of ECBs availed of both under the automatic and the approval routes, subject to all other terms and conditions of the ECB remaining unchanged.

Designated AD banks should, however, ensure that the proposed currency of borrowing is freely convertible.

#### c) Change of the AD bank

Designated AD Category - I banks may allow change of the existing designated AD bank by the borrower company for effecting its transactions pertaining to the ECBs subject to No-Objection Certificate (NOC) from the existing designated AD bank and after due diligence.

#### d) Changes in the name of the Borrower Company

Designated AD Category - I banks may allow changes in the name of the borrower company subject to production of supporting documents evidencing the change in the name from the Registrar of Companies.

All other aspects of ECB guidelines and

reporting requirements remain unchanged.

(Matter on FEMA has been contributed by CA. Manoj Shah and CA. Hinesh Doshi)

## **CORPORATE LAWS**

### **1. Quarterly Reporting by Foreign Venture Capital Investors (FVCI)**

[www.sebi.gov.in](http://www.sebi.gov.in)

The SEBI has issued Circular No. SEBI/IMD/DOF-1/FVCI/CIR-1/2010 dated 12.01.2010 whereby the format for the quarterly report on venture capital activity to be submitted by Foreign Venture Capital Investors has been revised. In accordance with Regulation 13 (1) of SEBI (Foreign Venture Capital Investors) Regulations, 2000, all Foreign Venture Capital Investors are directed to submit the report on venture capital activity to SEBI complete in all respects in the new format with effect from the quarter ended 31<sup>st</sup> March, 2010 which is to be uploaded online on SEBI portal within 7 days from the end of each calendar quarter. Physical copies of the report are not required to be submitted and the domestic custodian shall be responsible for timely submission of the report. One may refer to the above website for further details and the quarterly reporting format. Similar amendments are also done to the Quarterly Reporting by Venture Capital Funds by circular no. SEBI/IMD/DOF-1/VCF/CIR-1/2010 dated 11.01.2010.

### **2. Mandatory requirement of 'In-person' verification of clients**

[www.sebi.gov.in](http://www.sebi.gov.in)

The SEBI has issued Circular No. SEBI/MIRSD/Cir. No. 02/2010 dated 18.01.2010 whereby it is clarified that the 'in person' verification done for opening beneficial owner's account by a Depository Participant (DP) will hold good for opening trading account by a stock broker and vice versa, if the stock broker and DP is the same entity or if one of them is the holding or subsidiary company of the other. This circular is issued to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and shall come into effect from the date of this Circular. One may refer to the above website for further details.

### **3. Advertisement by mutual funds**

[www.sebi.gov.in](http://www.sebi.gov.in)

The SEBI has issued Circular No. SEBI/IMD/CIR No.2/191378/2010 dated 18.01.2010 whereby it has noted that the advertisements issued by mutual funds are generally lengthy and hence these disclosures are not bought to the attention of the investors. Now, it is clarified in order to make these statements more prominent, it is advised that the disclosures as stated in Clauses 10, 13 and 14 of Schedule VI

of SEBI (Mutual Funds) Regulations, 1996 on Advertisement Code shall be printed in bold and that all mutual funds shall comply with these requirements in letter and spirit. One may refer to the above website for further details.

### **4. Retail Issue of Subordinated Debt**

[www.rbi.gov.in](http://www.rbi.gov.in)

The RBI has issued Circular No. DBOD.BP.BC.No. 69/ 21.01.002/ 2009-10 dated 13.01.2010 on the retail Issue of Subordinated Debt for Raising Tier II Capital and with a view to enhancing investor education relating to risk characteristics of regulatory capital instruments, banks issuing subordinated debt to retail investors are advised to adhere to the conditions like, (a) requirement for specific sign-off as given in the above circular, (b) for floating rate instruments, banks should not use its Fixed Deposit rate as benchmark, and, (c) that all the publicity material, application form and other communication with the investor should clearly state in bold letters (with font size 14) how a subordinated bond is different from fixed deposit particularly that it is not covered by deposit insurance. One may refer to the above website for further details.

### **5. Guidelines on trading of Currency Futures**

[www.rbi.gov.in](http://www.rbi.gov.in)

The RBI has issued Circular No. A.P. (DIR Series) Circular No. 27 dated 19.01.2010 and that currently, persons resident in India are permitted only to trade in US Dollar (USD) - Indian Rupee (INR) currency futures contracts in recognised stock exchanges. In order to facilitate direct hedging of currency risk in other currency pairs as well, it has been decided, as announced in the Second Quarter Review of Monetary Policy 2009-10 (Para 117), to permit the recognised stock exchanges to offer currency futures contracts in the currency pairs of Euro-INR, Japanese Yen (JPY)-INR and Pound Sterling (GBP)-INR, in addition to the USD-INR contracts, with immediate effect. One may refer to the above website for further details and the full copy of the notification appended to the circular.

### **6. Requirement of Fee Clearance and NOC**

[www.sebi.gov.in](http://www.sebi.gov.in)

The SEBI has issued Circular No. SEBI/MIRSD/Cir. No.03/2010 dated 21.01.2010 stating that presently the members of the stock exchanges are required to obtain 'NOC' from SEBI through the respective stock exchanges before claiming refund of excess Base Minimum Capital from the stock exchange and are required to obtain 'fee clearance' from SEBI through the respective stock exchanges for the certain purposes like, (a) change in shareholding pattern without change in control, (b) issue and redemption of preference shares, issue of bonus shares, and, (c) change in directors other than

designated / whole time directors. It is now clarified on a review that these provisions shall, henceforth, be not applicable to the certain categories of members of the stock exchanges like, (a) trading members and clearing members in the equity derivatives and currency derivatives segments, (b) stock brokers in the cash segment who are covered under Schedule III A [payment of fees by stock brokers] of the SEBI (Stock Brokers and Sub-brokers) Regulations, 1992, and, (c) stock brokers in the cash segment who may migrate to Schedule III A [payment of fees by stock brokers] of the SEBI (Stock Brokers and Sub-brokers) Regulations, 1992 in future (as and when they migrate). One may refer to the above website for further details.

### **7. Disclosure of investor complaints and arbitration details on Depository website**

[www.sebi.gov.in](http://www.sebi.gov.in)

The SEBI has issued Circular No. SEBI/MRD/ OIAE/ Dep/ Cir- 4/2010 dated 29.01.2010 based on feedback received from investors and investor associations to improve transparency in the 'grievance redressal mechanism'. Based on the feedback and inputs received from them transparency in 'grievance redressal' is identified as a key area to augment investor protection. It is envisaged that transparency will also improve the general functioning of the market by providing investors the wherewithal to make informed choice. It is now mandatory that the Depositories shall henceforth disclose the details of complaints lodged by Beneficiary Owners (BO's)/ investors against Depository Participants (DPs) in their website. The aforesaid disclosure shall also include details pertaining to arbitration and penal action against the DPs in specific report formats as available at the above citation. One may refer to the above website for further details and reporting formats.

### **8. Currency Futures on Additional Currency Pairs**

[www.sebi.gov.in](http://www.sebi.gov.in)

The SEBI has issued Circular No. SEBI/DNPD/Cir- 52 /2010 dated 19.01.2010 regarding Exchange Traded Currency Derivatives and it has now been decided to permit eligible Stock Exchanges to introduce currency futures on Euro-INR, Pound Sterling-INR and Japanese Yen-INR. The details in terms of product design, margins and position limits for the three additional currency pairs are as given in the Annexures to the above circular. The circular has also modified the calendar spread margin to be applied on the US Dollar-INR contract which is also available in an Annexure to the above circular. One may refer to the above website for further details and the annexures.

(Matter in Corporate Laws has been contributed by CA. Jayesh Thakur)

## DISCIPLINARY CASE

*Summary of a disciplinary case - Council of the Institute of Chartered Accountants of India Vs. Deepak Parti & Anr. 1 (Chartered Accountant Reference No. 2 of 2005) decided on 25.10.2007 by the High Court of Delhi, under Section 21(5) of the Chartered Accountants Act, 1949.*

### Facts of the case

Mrs. Lakshmi Rani Hazra, Kolkata, (hereinafter referred to as the "Complainant") filed a complaint against Shri Deepak Parti, Chartered Accountant (Membership No. 83787), New Delhi, (hereinafter referred to as the "Respondent") under Section 21 of the Chartered Accountants Act, 1949 (hereinafter referred to as the 'Act') to the Institute of Chartered Accountants of India (hereinafter referred to as the 'Institute') alleging, inter alia, that the Respondent in his capacity as Vice-Chairman promoted a NBFC known as M/s Schematic Finance Ltd. (hereinafter referred to as SFL). The Complainant and her son Priyabrata Hazra were regularly investing in the SFL since April, 1997 onwards in the SFL's Super Flexi Note Scheme for 31 to 91 days. SFL used to forward the post dated cheque at par of the whole amount including the interest. In December, 1997, the Complainant invested a total amount Rs.6,70,000/- with SFL and received the post-dated cheques. But, from 7-2-1998 onwards, the cheques were returned by the Banks because of withdrawal of 'At Par Facility'. Subsequently SFL also closed down its 'Calcutta Branch Office'. As the cheques remained unencashed, on enquiry with CARE the Complainant came to know that the printed rating of 'CARE's Highest Safety Rating' to SFL stands withdrawn since July, 1997. But the SFL is utilising and providing the Complainant with the 'application form' with the same rating. SFL was issuing from Calcutta office the "Temporary Deposit Receipt" containing Deposit Receipt Number, Date, Name, Address, Period of Deposits, etc. from the beginning. On 6-7-1998,

SFL asked the Complainant to return all cheques against which SFC issued/forwarded the CLB's repayment schedule order to the Complainant. In October, 1999, the SFL informed the Complainant that the payment will start from December, 1999. But, the Complainant did not receive anything from the SFL. In brief the acts and omission alleged against the Respondent was as under

- (i) The Respondent continued to use the CARE's highest safety rating on its application form despite the fact that CARE has withdrawn it from July 1997.
- (ii) The cheques issued by the Respondent for an amount of Rs. 6,95,996/- were dishonoured by the Banks and
- (iii) The Respondent failed to obey the Company Law Board's Repayment Schedule Order and indulged in cheating the innocent depositors.

The Council of the Institute prima facie opined that the Respondent was guilty of professional and/or other misconduct and referred the case to the Disciplinary Committee for enquiry. The Disciplinary Committee on perusal of the Complaint, documents and other papers on record came to the conclusion that the Respondent was guilty of professional misconduct falling within the meaning of "other misconduct" under Section 22 read with Section 21 of the Chartered Accountants Act, 1949.

The Council on consideration of the Report of the Disciplinary Committee alongwith the Written Representation of the Complainant, accepted the report of the Disciplinary Committee and found that the

Respondent was guilty of professional misconduct falling within the meaning of "other misconduct" under Section 22 read with Section 21 of the said Act. The Council decided to recommend to the High Court that the name of the Respondent be removed from the Register of Members for a period of six months. As required under Section 21(5) of the Act, the matter was forwarded to the Delhi High Court with the recommendations of the Council.

The Judgment of the Division Bench of the High Court of Delhi comprising of Hon'ble Mr. Justice Madan B. Lokur and Hon'ble Mr. Justice S.Murlidhar is summarized below:

### Decision of the Hon'ble Court:

The Hon'ble Court, on perusal of the records, found that the view taken by the Disciplinary Committee was the correct view in the facts and circumstances of the case. The Hon'ble Court observed that Shri Deepak Parti having decided to remain ex parte, there was nothing to disbelieve the version of the Complainant (Mrs. Lakshmi Rani Hazara) which was accepted both by the Disciplinary Committee as well as the Council of the ICAI.

The Hon'ble Court after examining the papers placed on record, accepted the recommendation made by the Council of the ICAI to the effect that Shri Deepak Parti should be removed from the Register of Members for a period of six months.

On overall consideration of the matter, the Hon'ble High Court accepted the finding & recommendation of the Council and ordered that the name of the Respondent be removed from the register of members for a period of six months.

<sup>1</sup> For full text of the Judgment please see Institute's publication viz. Disciplinary Case Vol IX, Part I, p. 320 or visit Editorial Board page at [http://www.icai.org/post.html?post\\_id=967&c\\_id=59](http://www.icai.org/post.html?post_id=967&c_id=59)

## Treatment of preliminary expenses incurred on incorporation of a company

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

### A. Facts of the Case

1. A company was incorporated in May 2008 as a wholly owned subsidiary of a Government of India enterprise under the administrative control of the Ministry of Oil and Natural Gas to implement city gas distribution by participating in the bidding process of Petroleum & Natural Gas Regulatory Board (PNGRB) and also to set up CNG stations across the National Highway Corridor. The company got the authorisation from PNGRB in the 1<sup>st</sup> round of bidding to implement city gas distribution in four cities. The company's shares are not listed on any stock exchange. The authorised and paid-up share capital of the company as on 31.03.2009 are Rs. 200 crore and Rs. 5 lakh, respectively. The company is in the implementation stage of the project of city gas distribution and CNG Corridor Project, and had not started its commercial production till 31.03.2009 and as such, its turnover is nil for the said accounting year.

2. The company has spent an amount of Rs. 1.26 crore towards incorporation expenses during the period 27.05.2008 to 31.03.2009. The querist has stated that since the company has not started commercial production, the 'Statement of Incidental Expenditure During Construction' has been prepared instead of profit and loss account, complying with the specific requirements of Part II of Schedule VI to the Companies Act, 1956, giving suitable disclosure of specific items of expenditure.

3. According to the querist, the amount of Rs. 1.26 crore spent for incorporation of the company (preliminary expenses) was charged to the Statement of Incidental Expenditure During Construction (IEDC) in terms of Accounting Standard (AS) 26, 'Intangible Assets', as these expenditures cannot be treated as intangible assets. The total amount of IEDC consisting of preliminary expenditure and other pre-operative expenses have been allocated

to capital work-in-progress (CWIP) on capital outlay basis to be capitalised in future and will become part of fixed assets on capitalisation. As per the querist, this was done in line with the provisions of paragraph 56 of AS 26 and paragraph 9.3 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006, which according to the querist, state that the expenditure incurred on start-up costs including preliminary expenses can also be treated as a component of cost of fixed assets. The querist has also stated that start-up cost includes expenses incurred for formation of company (preliminary expenses) as per paragraph 56 of AS 26.

4. The expenditure other than those expenditure which are of capital nature, are booked by the company under incidental expenditure during construction (IEDC) and shown under CWIP. As per the querist, this IEDC forms part of the

project cost and on completion of the project is apportioned to ultimate assets on *pro-rata* basis in compliance with paragraph 9.2 of AS 10.

**B. Query**

5. The querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment of preliminary expenses adopted by the company is in compliance with the existing Accounting Standards and other generally accepted accounting principles. If not, how the same should be treated in the books of account in the current accounting year.

**C. Points considered by the Committee**

6. The Committee notes that the basic issue raised in the query relates to accounting treatment of expenses incurred on incorporation of the company. The Committee has, therefore, examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, treatment of other pre-operative expenses which are not incurred on incorporation of the company, etc.

7. The Committee notes paragraph 56 of AS 26 which is reproduced below:

“56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:

- (a) expenditure on start-up 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);
- (b) expenditure on training activities;
- (c) expenditure on advertising and promotional activities; and
- (d) expenditure on relocating or re-organising part or all of an enterprise.”

The Committee notes from the above that the start-up costs referred in AS 26 relates to costs of starting up an activity that may include incorporation expenses incurred in bringing an enterprise into existence as a separate legal entity, as well as expenditures for commencing new operations or launching new products. The Standard lays down a general rule that expenses of such nature should be expensed as no intangible asset or other asset is acquired or created that can be recognised, unless such expenditure is required to be capitalised as a part of the cost of a fixed asset as per AS 10. In this regard, the Committee notes the requirements of AS 10 notified under the Companies (Accounting Standards) Rules, 2006, which are contained in paragraph 9.3 of the Standard. The said paragraph is reproduced below:

“9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost....” (Emphasis supplied by the Committee.)

8. From the above, the Committee is of the view that the above reproduced paragraph of AS 10 refers to those start-up costs which are incurred on the start-up and commissioning of a *capital project* before the commencement of commercial production, such as, expenditure on test runs, etc., and not on incorporation of the enterprise. Thus, in the view of the Committee, the start-up costs of the nature of incorporation expenses incurred for bringing the enterprise into existence in its corporate form cannot be said to be attributable to bringing an asset/project into existence. Accordingly, the same cannot be capitalised even as an indirect element of cost of the asset/project. Thus, in the view of the Committee, the requirements of AS 26 would apply to the expenditure incurred on incorporation of the company and not the requirements of AS 10. Accordingly, in accordance with AS 26, such expenditures should be expensed by way of a charge to the profit and loss account in the period in which these are incurred. The Committee is of the view that for this purpose, profit and loss account will have to be prepared by the company even before the commencement of commercial operations. Further, since in the year of incurrence, the expenditure on incorporation of the company has been treated incorrectly by the company, the same should be rectified in the current year as a 'prior period item' in accordance with the requirements of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'. The Committee

notes that paragraph 15 of AS 5 requires that **“the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived”**.

9. The Committee also notes from the Facts of the Case that the querist has also referred paragraph 9.2 of AS 10 for apportionment of the IEDC comprising incorporation expenses to ultimate assets on *pro-rata* basis (paragraph 4 above). The Committee is of the view that paragraph 9.2 of AS 10 is applicable only when the expenses are attributable to construction of a project or to the acquisition of a fixed asset or bringing the asset(s) to its(their) working condition. As discussed in paragraph 8 above, the incorporation expenses cannot be said to be related to bringing an asset/project into existence and accordingly, the said paragraph of AS 10 also does not apply in the present case.

**D. Opinion**

10. On the basis of the above, the Committee is of the opinion that the accounting treatment of preliminary expenses constituting the expenses incurred on incorporation of the company, as adopted by the company, is not in compliance with the existing Accounting Standards and other generally accepted accounting principles. The same should be expensed by way of a charge to the profit and loss account in the period in which the same is incurred. Since the same has been treated incorrectly by the company in the year of incurrence, it should be rectified in the current year and disclosed appropriately as a prior period item in accordance with AS 5.

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2. The Opinion is based on the facts supplied and in the specific circumstances of the querist.
3. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty six volumes. A CD of Compendium of Opinions containing twenty five volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its Regional Council offices at Mumbai, Chennai, Kolkata and Kanpur.
4. Recent opinions of the Committee are available on the website of the Institute at URL: [http://www.icai.org/category.html?c\\_id=146](http://www.icai.org/category.html?c_id=146)

# Audit of Investments in a Bank's Treasury

Investments held by banks not only reflect the health of the bank, but also are an indicator of quantum and proportion of the deployment of public funds. Consequently, the focus and significance of this important component on a bank's balance sheet is unparalleled. An audit of investments requires an understanding of the management's plan, its control environment, policy setting and monitoring mechanism. An audit plan which considers and verifies compliance with various regulatory requirements is essential for an audit of a bank's investment portfolio. Further investments are exposed to all significant risks impacting a bank's business and consequently increase the risk quotient involved in the audit.



CA. Akeel Master CA. Ashwin Suvarna

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## Why Audit Investments?

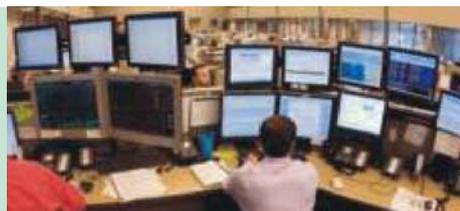
Investments constitute a significant percentage of a bank's balance sheet. Irrespective of the nature of operations of a bank they hold investments to meet their statutory liquidity ratio (SLR) requirements. Consequently, considering the volume, varied instruments in the investment book, recognition and valuation challenges and regulatory focus, the significance of investments as an audit area increases manifold. Further, auditors are required to report on compliance with guidelines mandated in Master Circular – Prudential norms for classification, valuation and operation on investment portfolio by banks (hereinafter referred to as Master Circular).

## Key Constituencies in an Investment Audit

Investment trades are entered in to by banks generally for proprietary and SLR purposes and it is imperative to understand a bank's investment policy before one commences the audit. The key drivers influencing an investment decision are:

- *Operating model:* Is the bank treasury centric (does treasury

Typically the investment desk in a treasury are compartmentalized into different types of instruments being dealt with. This compartmentalization is primarily done based on expertise of the treasury personnel dealing with a particular type of instrument. Consequently the treasury P&L are also monitored based on these separate desks.



income constitute a significant component of revenue)?

- *Market conditions:* Interest rate movements, liquidity, etc.
- *ALM mix:* Asset:Liability composition with regards to maturity, risk weights, etc. determine the portfolio mix of the investment portfolio
- *Regulatory consideration*

### Introduction to Investment Process

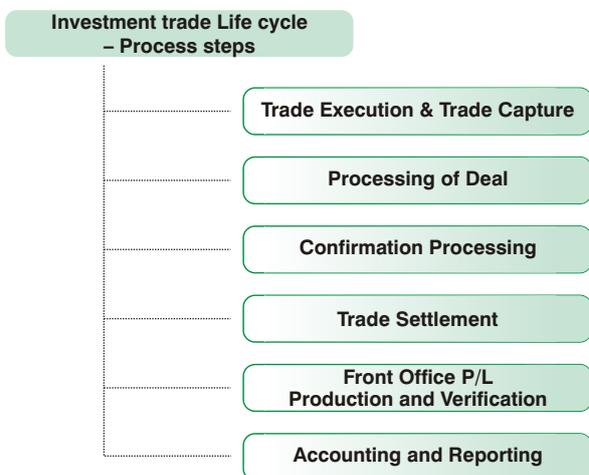
- *Policy:* Investment policy drives the investment decisions and the composition of the investment book. The policy, among others, incorporates the approval matrix, investment mix, classification of investments, frequency of reviews, valuation methodology and the value at risk (VaR) assessment;
- *Treasury Desk:* Typically the investment desk in a treasury are compartmentalized into different types of instruments being dealt with. This compartmentalization is primarily done based on expertise of the treasury personnel dealing with a particular type of instrument. Consequently the treasury P&L are also monitored based on these separate desks. Each desk is provided with a mandate originating from the investment policy and the asset liability management (ALM) strategy;

- *Trade execution:* Buy/sell transactions are executed by these desks either directly or through intermediaries – exchanges, custodians, agencies etc.;
- *Settlement:* Transactions are generally settled within the mandated market practice – typically T+2. Settlement of trades done through exchanges and RBI nodal agencies are done electronically, e.g. negotiated dealing system (NDS) is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments;
- *Recording:* Transaction capturing is an important aspect of investment trades. Timeliness and accuracy of monetary and non monetary information of trades is essential to ensure completeness of binding trades. Typically, banks follow trade date accounting and same can be reconfirmed with custodian and depository statements.

### Investment Options in Short-term and Long-term Investment Market

Banks deal in wide range of instruments, some of commonly traded securities are:

- *Short-term instruments:* Call/notice/term money, repo/reverse repo, inter corporate deposits, commercial paper, certificate of deposit, T-bills, and inter-bank participation certificate
- *Long-term instruments:* Government securities, corporate debt instruments, equity instruments and others



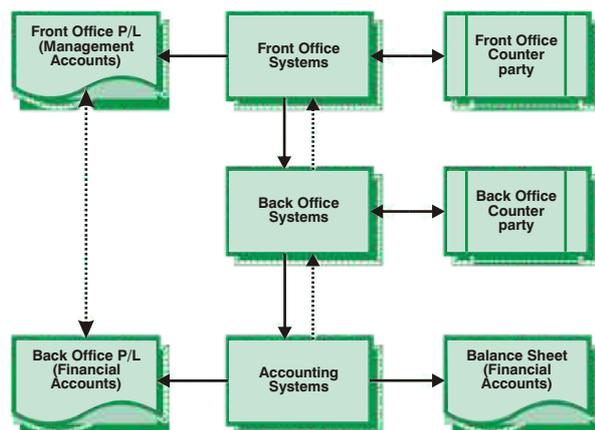
### The Investment Infrastructure

An executive committee comprising of senior management personnel decide and empower the Treasury personnel to transact based on the bank's investment strategy. These strategies are periodically reviewed, assessed and reconfirmed based on the existing market conditions and the bank's financial needs.

Most banks operate on a front office, middle office and back office model and hence do have the necessary role definition for each of such

functions. The following are their roles and significance:

- The role of the front office is to execute the mandated trades and bind the bank into a commitment to either purchase or sell securities. Front office is an important constituent in determining timing of the trades that originates transactions.



- Middle office measures the risk appetite and assesses the open position against the set acceptable range measured through various risk management tools. The middle office is also involved in valuation model verifications and independent price verifications.
- Back office is responsible for data integrity, reconciliations, collating documentary evidences and verifying authenticity of trades. It is also responsible to ensure completeness of trade capturing in the accounting system.

### Controlling Investment Risks

The following, though not an exhaustive list, are some of the key risks which impact investments in a bank's portfolio:

- *Market risk:* A bank's investment portfolio is significantly exposed to market-risk constituents, namely interest, equity prices and currency. The implied volatility in each of these impacts the valuation and returns on the investment portfolio. Consequently various market-risk measurement techniques are employed by banks to constantly monitor and

assess the value at risk.

- *Credit risk:* Due to the RBI regulations, banks hold a large proportion of their investments in rated, SLR securities. However, they generally still do have limited exposures to capital markets and other instruments issued by corporate houses. Recently, credit risk has been a serious issue of consideration as it has severely impacted the liquidity of such instruments. Consequently, a big challenge for banks is to manage immediate funding requirements in case of inadequate liquid markets.
- *Operational risk:* As discussed before, bank's treasury has to be supported by a strong infrastructure to ensure timely trade execution, booking and settlement. Any breakdown in the process could impair the real time settlement of trades. Further various checks and balances are essential for the key activities performed in life cycle of a trade so as to ensure that transactions are real, valid and legally binding.
- *Regulatory compliance:* Banks operate in a highly regulated environment and there are rules governing the composition and volume of investments. Hence banks have to constantly monitor compliance with these guidelines so as to avoid strictures from the regulator.

### The Regulatory Aspect

The following is a brief background of the key RBI guidelines governing a bank's investment portfolio:

#### Categories and Classification

The investment book has to be bifurcated into the following three categories:

- Held to maturity (HTM),
- Available for sale (AFS) and
- Held for trading (HFT).

These categories determine the valuation principles for each instrument forming part of the respective categories. These categories also determine the size of the investment book, e.g. subject to some exemptions a bank's HTM investment portfolio cannot exceed 25 per cent of the total investments. Investments in the above categories are further classified as:

**Middle office measures the risk appetite and assesses the open position against the set acceptable range measured through various risk management tools. The middle office is also involved in valuation model verifications and independent price verifications.**



Due to the RBI regulations, banks hold a large proportion of their investments in rated, SLR securities. However, they generally still do have limited exposures to capital markets and other instruments issued by corporate houses. Recently, credit risk has been a serious issue of consideration as it has severely impacted the liquidity of such instruments.



- Government securities
- Other approved securities
- Shares
- Debentures & Bonds
- Subsidiaries/joint ventures
- Others (CP, Mutual Fund Units, etc.)

The above classifications determine the amount available for setting off appreciation in value in one instrument against any depreciation in valuation in the same category and classification. Further, the presentation in the financial statement is also as per this classification in the investment schedule.

#### Valuation Norms

- *HTM*: Investment needs not be marked to market and is carried at acquisition cost, unless it is more than the face value, in which case the premium is amortized over the period remaining to maturity.
- *AFS and HFT*: Individual investment scrips in these categories are required to be marked to market. Appreciation/depreciation is aggregated for each classification, as discussed above, under the respective categories. Net depreciation is provided and net appreciation is ignored.

#### Other Important Rules

- Separate accounting rules specified in the Master Circular for repo and reverse repo transactions.
- Rules for shifting of investments from HTM to AFS and from AFS to HFT.
- Restrictions on holding certain types of investments, e.g. banks cannot invest in non SLR securities of original maturity of less than one year other than in Commercial Papers and Certificate of Deposits.
- Determination of non-performing investments (NPI).

#### The Control Environment

The processes discussed above needs to incorporate a strong control culture. Some of key controls which are observed and are expected in a bank's treasury are:

- Board/equivalent body approves the investment policy.
- Investment decisions are governed by the investment policy.
- Regular monitoring of the exposure and VaR.
- Adequate limit monitoring mechanism is established to assess broker limits, trader limits, investment category limits, etc.
- *System reconciliations*: Various IT modules involved in data capturing and recording are reconciled on a daily basis and exceptions are investigated.
- *Nostro reconciliations*: Bank accounts involved in settlement of investment trades are periodically reconciled and exceptions are investigated.
- *Counterparty/custodian confirmation*: Process instituted to ensure that timely confirmations are obtained to verify authenticity of trades.
- For investments certificates which are held in physical form, i.e. not dematerialized, a physical verification exercise is undertaken at periodic interval.
- Controls are instituted to ensure that all corporate actions such as dividend, bonus shares, etc., are recorded and corresponding accounting entries are made.
- Controls to monitor that no off-market trades are done, e.g. after closure of markets, on holidays, etc.
- Mandatory leave policy for employees.
- *Segregation of duties and job rotation policy*: Front office and back office operations are segre-

gated and there is no compromise on access to the respective functions.

- Since most of the operations are undertaken in an automated environment, there is generally a strong IT-driven control environment with predefined access control and change control definition. Various reviews are mandatorily incorporated in the IT application and, hence, these are critical elements for the trade capturing.

### Auditor's Eagle-Eye Approach

Important considerations while planning an investment audit in a bank are:

- *Policy*: Review the investment policy and note any updates and ensure that the same has been adopted and approved by the Board or an equivalent body.
- *IT Environment*: Understanding the IT infrastructure is important to determine the audit strategy to verify and gather adequate audit evidence for testing effectiveness of controls in the investment process.
- *Categories*: Verify that the categories, i.e. AFS, HTM and HFT, have been determined on day one, and appropriate documentation of intention is available to support the designation of instruments into each category.
- *Completeness*: Cross verify front office-back office reconciliation for ensuring that all trades have been captured in the accounting system. Further, sighting custodian and SGL statements is also an essential exercise to ensure that the positions are authenticated through external evidences.
- *Cut-off procedure*: Verify subsequent settlement of trades done on the reporting date.
- *Reconciliation*: It is imperative to verify various reconciliations varying from bank to bank, like receivable/payable accounts, parking/ suspense accounts, etc. Further, an audit of nostro accounts would also provide evidences of any fraudulent or dubious trades.

- *Inter-category transfer*: Verify controls to ensure that there are no unauthorised transfers between categories during the period under audit.
- *Profit & loss computation at the time of sale*: Controls and process around determination of appropriate cost, based on the bank's policy, e.g. weighted average cost computation, along with the sale consideration is an integral part of an investment audit programme.
- *Sight indicators for non-performing investments (NPIs)*: Interest/dividend defaults, linkages to non-performing advances and non-availability of latest financial statements, etc.
- Follow rules for accounting as specified in the Master Circular for repo/reverse repo trades.
- *Valuation considerations*:
  - Verify compliance with valuations methodology given in the Master Circular.
  - Correct closing prices (as the reporting date) are considered for valuation purposes.
  - Verify that the correct yields published by FIMMDA are considered for valuations of instruments wherein prices are derived based on yields.
  - Verify appropriate mark-up adjustments are made on yields wherever essential and prescribed.

### Conclusion

A focus approach spanning across all key elements of an investment transaction is essential for an audit of this area. An auditor has to capture and touch upon the control environment instituted by the bank to ensure that investment transactions are correctly and timely recorded. Consequently, an audit of investments without testing the effectiveness of controls in the bank's treasury would be incomplete and ineffective. ■





# Application of Principles of Materiality in Bank Audit

The old debate whether auditors are blood hound or watchdog is a passé. Today's auditors hold out in their report that they have a reasonable basis for their opinion that the financial statements do not contain a material misstatement. In bank audit substantial reliance is placed on the work of branch auditors. The Statutory Central Auditors (SCAs) of a bank, therefore, have to determine the materiality level at the financial statement level and apportion the same to the components and advise the auditors of the components. This article gives a basis to determine the materiality at the component level based on the materiality set at the financial-statement level by the SCAs. It shows that if performance materiality at the financial statement level is set at 1 per cent of the net profit of the bank, then at such a low margin for error the branch auditors may not conclude if financial statements of the branch do not contain a material misstatement.



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## Background

### 1. Need to define Materiality

Auditors make the following averments in their audit report:

"These financial statements are the responsibility of the Company's management. *Our responsibility is to express an opinion on these financial statements based on our audit.*

We conducted our audit in accordance with auditing standards generally accepted in India. *Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.* An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the

accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. *We believe that our audit provides a reasonable basis for our opinion.*"

The italicised sentences are the basis for this article. An averment that the audit has been carried out to obtain a reasonable assurance that the financial statements are free from material misstatement, requires the auditors to be clear as to what constitutes a material misstatement and the same should be documented in their working papers. The old debate whether auditors are blood hound or watchdog is a passé. Today's auditors hold out in their report that they have a reasonable basis for their opinion. This basic requirement of the auditing standards, which require documentation of materiality is yet to be practiced in large way in India.

The current practice in India is to carry out a comprehensive audit to discover the errors in the draft financial statements. Discovered errors are rectified. Where audit is carried out by test check, it is usually on judgemental sample basis. Consequently, it is very difficult for the auditors to estimate with reasonable confidence the residual errors which are not discovered. Audit evidence tests the assertions of existence, occurrence, measurement and valuation. However, the auditors have to establish that the assertion of "completeness" has been properly tested if they were to meet the criteria that the audit evidence is sufficient and appropriate that all material misstatements have been located or the residual misstatements are not expected to be material in order to issue an unqualified report (as per latest version of AAS 28 now auditing standard SA 700 the report would be expressing an "unmodified opinion").

In the case of banks where the audit is carried out jointly by Statutory Central Auditors (SCAs), they have to jointly agree on the materiality at the financial statements level. As the audit is carried out by them and other auditors at branches and other offices of the bank, they have to allocate the materiality at the financial statements level of the bank to the components – Branch, Z.O/ R.O/D.O. levels and H.O. Departments, etc., and inform the materiality level to the auditors of the components. Based on the materiality level assigned by the SCAs to components, the auditors of these components have to carry out their audit and report to the

SCAs. The opinion from the component auditors on their respective financial statements based on the assigned level of materiality assists the SCAs in forming an opinion on overall financial statement level.

The concept of materiality is applied by the auditors both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditors' report. Many banks for example do not defer income received in advance, particularly in respect of commission and exchange. Some auditors are found to qualify their reports, others have not. In both the cases the audit documentation should contain the basis for the opinion. Hence, it is essential that materiality levels are clearly established at inception of the audit by consultation amongst the auditors and with the management of the bank. These materiality levels may undergo changes as the audit progresses.

## 2. Definition of Materiality

Materiality has been broadly defined in the Accounting Standards and the Assurance Standards in the following manner.

"An item is considered material if the knowledge of the same affects the economic decision of the users".

The financial statements prepared by banks are general purpose financial statements which are not specifically addressed to the information needs of any particular category of users. Paragraph 10 of ICAI's "Framework for the Preparation and Presentation of Financial Statements," indicates that for a profit-oriented entity:

"as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements."

One must be very clear that the auditors should not only report overstatement of profit, they should also report understatement of profit (subject to the floating provision allowed to banks).

## 3. Utility of Materiality Concept

Audit is a reasonable assurance engagement. Auditors are not able to obtain and provide absolute assurance from their audit procedures. Therefore, definition of materiality helps the

auditors to carry out their audit in an efficient and effective manner.

In a layman's language an unqualified audit report provides assurance that the financial statements are "good enough" to meet the information needs of those users who are equity shareholders in the bank. For financial statements to be "good enough", the tolerance limits within which misstatements could remain undetected/uncorrected and not affect the reliability of the financial statements for such users have to be defined. That in essence is the materiality level. The audit is planned and performed at obtaining "a reasonable basis" for the opinion. Auditors of nationalised banks have also to be sensitive to the needs of the Government.

**Establishing Materiality Levels at Financial Statement Level**

4. Pronouncements of the following bodies and regulators would be of use for the SCAs in determining the materiality levels at the financial statement level.

**IAPC:**

Extract from *The Audit of International Commercial Banks* prepared by the *International Auditing Practices Committee (IAPC)* of the International Federation of Accountants after consultation with the Basle Committee on Banking Supervision:

*"Materiality*

4.14 In making an assessment of materiality, in addition to the considerations set out in ISA 320 "Audit Materiality," the auditor must keep in mind that:

- because of high gearing, relatively small errors may have a significant effect on the statement of earnings and on capital, though they may have an insignificant effect on the balance sheet itself;
- as the net income of a bank is low when compared to its gross assets and liabilities and its off balance sheet commitments, errors which relate only to assets, liabilities and commitments may be less significant

than those which could also relate to the statement of earnings; and

- banks are often subject to regulatory requirements, such as the requirement to maintain minimum levels of capital. It would therefore be necessary to set materiality levels which should identify errors and audit differences which, if uncorrected, would result in a significant contravention of such regulatory requirements."

**ICAI:**

*SA 320 (Revised) Materiality in Planning and Performing an Audit.*

This standard provides a detailed step by step guidance to the auditors. Though SA320 (Revised) is mandatory for audits of financial statements for accounting periods commencing after 01-04-2010, the revised SA is issued under the "Clarity Project" of ICAI and the requirements therein are not new. In the author's opinion, the revised Standard provides detailed guidance on application of the principles of materiality already contained in existing SA320 and standards which are already in force as on 31-03-2010.

**RBI:**

RBI in its Circular DBOD No.BP.BC.89/21.04.018/2002-03 dated March 29, 2003 has clarified that banks will comply with the requirements of AS-5 – *Prior Period and Extraordinary Items, Changes in Accounting Policies* as follows:

"Paragraph 4.3 of *Preface to the Statements on Accounting Standards* states that Accounting Standards are intended to apply only to items which are material. Since materiality is not objectively defined, it has been decided that all banks should ensure compliance with the provisions of the Accounting Standard in respect of any item of prior period income or prior period expenditure which exceeds one percent of the total income/ total expenditure of the bank if the income/ expenditure is reckoned on a gross basis or one percent of the net profit before taxes or net losses as the case may be if the income is reckoned net of costs."

Accordingly, the RBI circular holds each



**In a language which is not technical, the auditors report whether the financial statements are "good enough" to meet the information needs of the users who are equity shareholders or investors in the bank. In case of nationalized banks, a major investor is the Government and the auditors have to be sensitive to the needs of the Government.**

individual mistake should exceed 1 per cent of the gross income or gross expenditure to be considered material. However, if income is determined on a net basis, e.g. profit on sale of investments, the disclosure will arise if the prior period item under that head exceeds one percent of the net profit before taxes or net loss as the case may be.

This clarification quantifies the amount of a mistake made in the financial statements of the prior period as to be considered as material and requiring disclosure in the accounts of the current year, and therefore provides an authoritative basis from the regulator for auditors including SCAs of an upper limit for the purposes of materiality. Therefore, the profit & loss account of a bank could be said to be materially misstated, if it contains an error which exceeds the total income or expenditure of the bank if the income/expenditure is reckoned on a gross basis or 1 per cent of the net profit before taxes or net losses as the case may be if the income is reckoned net of costs. There is no similar guidance from RBI on materiality at the Financial Statement Level.

#### SEBI:

SEBI requires in the clause 41 of the listing agreement:

“where there is a variation between the unaudited quarterly or year to date financial results and the results amended pursuant to limited review for the same period, and –

- (i) the variation in net profit or net loss after tax is in excess of 10 per cent or Rs.10 lakhs, whichever is higher; or
- (ii) the variation in exceptional or extraordinary items is in excess of 10 per cent or Rs.10 lakhs, whichever is higher -

the company shall submit to the stock exchange an explanation of the reasons for variations, while submitting the limited review report. The explanation of variations so submitted shall be approved by the Board of Directors:

Provided that in case of results for the last quarter, the above sub-clause shall apply in respect of variation, if any, between the year to date figures contained in the unaudited results and the figures contained in the annual audited results.”

In view of the above, the materiality level at the financial statement level of the bank would be 10 per cent or Rs. 10 lakhs whichever is higher, variation within these limits does not require

explanation from the Board to SEBI. Though Boards generally adopt accounts only after audit, the accounts remain unaudited till signed by the auditors. However, the monetary margin of Rs. 10 lakh for a bank may be too low and the SCAs would have to decide on an appropriate margin depending on the size of operations of their respective banks by applying the principles set out in SA320 (Revised).

5. An important input would be the bank's own internal assessment of materiality which forms the basis for the CEO and CFO certificate that financial statements do not contain a material misstatement which is laid before the Board along with the financial statements. It is desirable that the certificate should be accompanied by a note detailing the basis and parameters on which materiality has been determined.

#### Establishing Materiality Levels for the Audit

6. In establishing the materiality for purposes of the overall audit strategy principles from SA320 (Revised) have to be applied such as:

- Determine materiality for financial statements as a whole

Identifying one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements and the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures (e.g. Related Party Disclosures, Penalties paid by the Bank)

- Selecting appropriate benchmarks:

For bank audit following benchmarks could be identified as key benchmarks: Operating Profit, Net Profit, Gross NPA, Net NPA, and Capital Adequacy Ratio. Other benchmarks could be identified by the auditor if they are considered relevant.

Materiality levels could be set as a percentage of the above key benchmarks or as an absolute figure, e.g. materiality in respect of the net profit could be 10 per cent of the Net Profit or Rs. 50 crore whichever is higher.

In relation to the chosen benchmarks, identify relevant financial data such as prior periods' financial results and financial positions, the period-to-date financial results and financial



**Materiality level adopted at the financial statement level at the maximum should be the level adopted by the Board of the bank subject to the limits referred above of the RBI and the SEBI. However, while performing the audit, the auditors may adopt a lower level of materiality.**

position, and budgets or forecasts for the current period, as adjusted for significant changes in the circumstances of the bank, e.g. a significant business acquisition, and relevant changes of conditions in the industry or economic environment in which the bank operates, e.g. when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the SCAs to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalised profit before tax from continuing operations as against figures based on past or current results.

For the purposes of this article, some benchmark marks of four banks, two in the public sector (A, a large bank, and C, a small bank) and two in the private sector (B, a large bank, and D, a small bank), as extracted from their recent published results are listed in Table-1.

#### **7. Performance Materiality Level for the purpose of Central Audit**

Materiality level adopted at the financial statement level at the maximum should be the level adopted by the Board of the bank subject to the limits referred above of the RBI and the SEBI. However, while performing the audit, the auditors may adopt a lower level of materiality. The materiality level, adopted for planning and performing the audit is defined as "performance materiality", e.g. if the Board of the bank has adopted 10 per cent as the materiality level in respect of the Net Profit of the bank, the auditors could adopt a performance materiality level of 5 per cent for the purposes of their audit in respect of quantitative parameters. This will help in keeping the audit risk (the risk of an inappropriate opinion) low.

On qualitative issues, the auditors would ensure adherence to Accounting Standards and the RBI directions relating to disclosure and presentation in the financial statements including the Notes.

Table-2 gives the possible materiality and performance materiality levels for the four banks in

this study. As seen, at the financial statement level:

- The size of the bank makes a difference.
- The materiality at financial statement level at 1 per cent of the total income in the case of each of the four banks is much higher than 5 per cent but less than 10 per cent of their respective net profit. This in the opinion of the author supports the materiality levels as culled by him out from regulatory pronouncements above, i.e. 1 per cent of the gross income or expenditure for each line item in the Profit & Loss account and 10 per cent of the net profit after tax in the aggregate.

The above exercise has been made without adjusting for inappropriate accounting policies, e.g. non-deferment of income received in advance by way of commission on bank guarantees, locker rent, etc., if same is done then the margin for error gets further reduced and the SCAs would have to reduce the performance materiality appropriately.

#### **Apportioning Performance Materiality to Components**

##### **8. Determining Performance materiality for auditors of components - Branches**

Performance materiality in respect of each of the key benchmarks at the financial statement level referred to in paragraph 5 above has to be determined and apportioned to the components (branches and other offices of the Bank). The component audit has to be performed to ensure that residual mistakes in the component financial statements fall within the assigned materiality level. A clear measure for materiality at the component level would definitely help the component auditors to focus their audit. Unqualified component audit reports for the assigned materiality levels give confidence to the SCAs to express their opinion at the financial statement level.

For this purpose performance materiality at Financial Statement level could be possibly assigned to the components in the following manner.

Net Profit of a bank is arrived by deducting

from the Operating Profit, Provisions for NPA, Provision for Depreciation on Investments, Provision for Taxation and Other Provisions. Hence, performance materiality could be set for each of these components.

Just as the performance materiality at the overall financial statement level would be set lower than the acceptable threshold, the performance materiality allocated to the components could be at a lower level than at the financial statement level so that any errors in audit of a component may not have a material impact on the audit opinion at the overall financial statement level. Many members have expressed to the author that one percent materiality is appropriate. Hence for this discussion materiality at the branch level has been assigned at 1 per cent.

#### **A. Performance materiality for Operating Profit**

At the component level, i.e. branches, Zonal offices, H.O Departments, etc., it is the operating profit which is reported in the individual financial statements as the provisions are made at H.O. Hence, for the reported profit or loss of a component, it is advisable to determine the materiality for the operating profit of that component.

##### **APPORTIONMENT BASED ON PROFIT OR LOSS OF THE BRANCH**

The operating profit or loss at the branch level is not complete, the full cost of funds are not reflected. For the same level of business, the results would vary from a high negative income in the case of a deposit oriented branch to a high profit in the case of advance oriented branch. Hence, it may not be appropriate to determine performance materiality as a per cent of the profit as disclosed in the profit & loss account of the branch.

##### **APPORTIONMENT BASED ON THE BUSINESS LEVELS OF THE BRANCH**

The operating profit for this purpose would be the total operating profit of the bank less the operating profit of certain specialised H.O. departments such as Treasury. One method for apportioning the performance materiality in respect of operating profit could be on the total business at the branch. If figure for the average business is available, the average business would be a better yardstick.

In the case of H.O. departments such as Treasury, performance materiality could be determined based on the operating profit or loss as per each department's respective profit & loss accounts. In the case of other departments, Zonal offices, etc., the materiality will have to be suitably

determined and apportioned. Performance materiality for audit of Treasury has to consider that the income is highly volatile.

An illustrative working is given in Table-3 showing how the materiality at the component level in respect of operating profit could be determined and apportioned based on the business of each branch. The audited financials of the four banks as on 31-03-2009 are used for this purpose.

The "Gross Profit from Branch Banking Operations" is arrived at by excluding from the operating profit of the bank the profit or loss of H.O. departments. In the example in Table-3 the profit from treasury operations have been derived and excluded. The Gross Profit from branch banking operations for every Rs. 10 crore of business is determined. As per Table-3, this works out to Rs 10,45,043 for bank A, Rs. 16,49,302 for bank B, Rs. 10,93,353 for bank C and Rs.7,35,100 for bank D. Accordingly the performance materiality at 1 per cent level at the financial statement level of the components of each bank for every Rs. 10 crore of business would be, Rs.10,450 for A, Rs.16,493 for B, Rs.10,933 for C and Rs.7,351 for D based on the financial statements for the year ended 31-03-2009. The performance of the banks for the 9 months ended 31-12-2009 over the corresponding figure for the previous period the figure will determine whether the figure of materiality requires any further adjustment. In communicating the materiality levels to the branch auditors the figures for every Rs. 10 crore of business at the branch, at 1 per cent performance materiality level could be suitably rounded off.

The above calculations demonstrate that between the banks there is very little difference on the materiality level at 1 percent level for every Rs. 10 crore of advances. The margin of error for auditors of small branches of 5 Crores at performance materiality level of 1 per cent is extremely small. Hence, the SCAs may have to fix a minimum performance materiality level, e.g. in respect of bank A the auditors could set the performance materiality for operating profit at Rs. 12,000 for every Rs. 10 crore of business or Rs. 50,000 which ever is higher.

The advantage of performance based materiality level fixed based on the business levels of the branch would ensure a more even distribution of work and responsibilities amongst branch auditors auditing a branch of the same size. The branch

audit fees which are presently based on the size of the advances needs to be appropriately structured. Today the focus of branch audit is more on classification of advances and not on other elements of the branch balance sheet and profit & loss account.

#### **B. Performance Materiality for provision for NPA**

The provision for NPA is tied to the identification of NPA at the branch. If the NPA is identified at the branch, the reversal of unrealised income, classification and provisioning follow.

Table-4 gives a basis for calculation of materiality in respect of identification of NPA at the branches. The Gross NPAs are divided by Gross Advances to arrive at the NPA level for every crore of advances. The NPA level for every Rs. 1 crore would be Rs.2,87,353 for bank A, Rs.1,10,079 for bank B, Rs. 65,423 for bank C and Rs.201592 for bank D. Hence in respect of identification of NPA, the margin for error for the auditor at a performance materiality level of 1 per cent would only be Rs. 2,873, Rs. 1,100, Rs. 654 and Rs. 2,015 for every Rs 1 crore of advances at the branches of the respective banks. Obviously, the branch auditors would require to do extensive substantive tests to satisfy themselves that all NPAs have been identified by the branch.

#### **C. Performance Materiality for Provision for Taxation**

Table-5 gives the working for performance materiality for detection of errors in Form 3 CD compiled by the branches. At 1 per cent level, the performance materiality for detection of errors in the compilation of Form 3 CD would be Rs. 13,676 for every Rs. 10 crore of business in the case of A, and Rs. 16,202 in the case of B, Rs. 4,593 for C and Rs.7,999 for D. This means that the branch auditors have to increase their substantive procedures at the branches to detect errors in the preparation of form 3CD, in particular, items such as disallowances under Section 40 (a) (ia). A cursory test check with disclaimer will not do if the performance materiality in respect of provision for taxation for the branch is set at 1 per cent level.

#### **D. Other Parameters:**

A key regulatory ratio is the Capital Adequacy

Ratio. The SCAs have to work out a methodology for materiality at the financial statement level and allocating thereof to the component level.

Accordingly the author is of the opinion that at the branch level that performance materiality has to be set at a much higher level than 1 per cent for audit to be practicable without compromising audit quality.

#### **9. Performance Materiality for Zonal Consolidation**

Banks have regional offices, zonal offices, etc., where the accounts of the branches and offices of the zone/region, both audited and unaudited, are consolidated. The SCAs consolidating the accounts at the zone are per se not auditing and reporting on the consolidated accounts of the zone (except perhaps in the case of the State Bank of India where central auditors are appointed to audit the consolidation at the Circle level). However, observations made in audit reports of audited branches would be relevant in estimating the value of undiscovered/unadjusted errors in financials of unaudited branches and their aggregate impact on the financial statements of the bank as a whole.

#### **Applications of Performance Materiality in Audit**

##### **10. Defining the Trivial**

Many members are of the mistaken impression that the communication received from banks not to report discovered errors within a cut off point conveys the materiality limits set for the branch audit. This is not so. It is only a communication of the errors considered as "not material" by the bank in consultation with the SCAs to speed up the consolidation process at H.O.

The new SA 450 *Evaluation of Misstatements Identified During the Audit* requires that all misstatements which are not trivial are rectified: According to the Standard,

“Clearly trivial” is not another expression for “not material”. Matters that are “clearly trivial” will be of a wholly different (smaller) order of magnitude than materiality determined in accordance



**The SCAs consolidating the accounts at the zone are per se not auditing and reporting on the consolidated accounts of the zone (except perhaps in the case of the State Bank of India where central auditors are appointed to audit the consolidation at the Circle level).**

with SA 320 (Revised), and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.”

In the light of the standard SA 450 as referred to above, only matters which are “clearly trivial” can be ignored. This assessment can only be based from assessment of materiality at the component level.

### 11. Performance materiality in performing the audit and reporting

The SCAs obtain assurance from their audit procedures that those potential areas for material misstatements, e.g. reconciliation of inter branch accounts, are properly addressed before issuing an unqualified report. Materiality of the uncorrected misstatements which are discovered or the estimate of the undiscovered misstatements determines the audit opinion. An unqualified opinion is issued when the aggregate of the value of the discovered errors which remain uncorrected and the estimated of undiscovered errors are within the materiality limits. Where the discovered error is material but not pervasive the auditor issues a qualified opinion quantifying the impact on the accounts of such error. An adverse opinion is issued, if the discovered error is considered material and pervasive. A disclaimer of opinion is issued where the auditors are unable to quantify the impact of the errors which are material and pervasive. If there are potential undiscovered errors on which auditor is not able to conclude that they are not material and these are pervasive, e.g. effect consequent to reconciliation of inter branch accounts, the auditors is required to issue a disclaimer of opinion.

### Documentation and Peer Review

12. Paragraph 14 of SA 320 (Revised) requires that audit documentation should include the following amounts and the factors considered in the determination of:

- Materiality for the financial statements as a whole
- If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures
- Performance materiality and
- Any revision of a) - c) as the audit progressed

The basis of apportioning performance materiality to the components would necessarily form part of the work papers of the SCAs and available to the Peer Reviewer. The Peer Reviewer would also

examine the basis for expressing the final audit opinion. These documents would necessarily require signature of all SCAs.

### Conclusion

13. Bank audit in India is a bottom-up exercise and substantial reliance is placed on the work of the branch auditors. If performance materiality is defined at the financial statement level and allocated to the branches then audit would become more purposeful. Therefore, not only must the SCAs apportion the performance materiality to the branch level, the branch auditors must communicate that they have considered the performance materiality level as assigned by the SCAs. To express an unqualified opinion at the assigned degree of materiality, the branch auditors would have to carry out extensive substantive testing to be confident that all material errors in the financial statements of the branch have been discovered and corrected. Hence much more time has to be factored in the time schedule by the management of the banks for branch audit than is provided now. It is suggested that the matter should be taken up with the RBI to define the performance materiality for the audit of banks and to ensure that the fees are also fixed appropriately. If the auditors are able to put numbers to their satisfaction, the audit and the financial statements would get more credibility.

**TABLE-1**  
Benchmarks of Selected Banks based on Audited Financials for 2008-09

Parameters	(Rs. in Crores)			
	A	B	C	D
Capital	634.88	359.01	383.06	64.12
Reserves and Surplus	57,312.82	9,854.58	1,757.29	360.36
<b>Business Parameters</b>				
Deposits	742,073.13	117,374.11	34,675.65	4,968.81
Advances	542,503.20	81,556.77	24,615.35	3,196.06
<b>Total Business</b>	<b>1,284,576.33</b>	<b>198,930.88</b>	<b>59,291.00</b>	<b>8,164.87</b>
Total Income	76,479.22	13,732.36	3,654.86	487.78
Interest Expended	42,915.29	7,149.27	2,235.31	286.80
Operating Expenses	15,648.70	2,858.21	691.84	113.07
Total Expenditure	58,563.99	10,007.48	2,927.15	399.87
Operating Profit	17,915.23	3,724.88	727.71	87.91
Provisions	8,794.00	1,909.52	290.53	30.46
Net Profit	9,121.23	1,815.36	437.18	57.45
Gross NPA	15,589.00	897.77	161.04	64.43
Net NPA	9,552.00	327.13	78.03	28.24
<b>Key Ratios</b>				
Capital Adequacy Ratio (%) as per Basel-I	12.97	13.69	11.88	14.44

(Banks A & C are in the public sector, Banks B & D are private banks)

TABLE 2

Materiality at the Financial Statement Level				
(Rs. in Crores)				
Parameters	A	B	C	D
Total Income	76,479.22	13,732.36	3,654.86	487.78
1% of Total Income	764.79	137.32	36.55	4.88
Total Expenditure	58,563.99	10,007.48	2,927.15	399.87
1% of Total Expenditure	585.64	100.07	29.27	4.00
Net Profit	9,121.23	1,815.36	437.18	57.45
% of net Profit	91.21	18.15	4.37	0.57
10% of Net Profit	912.12	181.54	43.72	5.75
5% of Net Profit	456.06	90.77	21.86	2.87

TABLE 3

Worksheet for Allocating Performance Materiality in respect of Operating Profit to Components				
(Rs. in Crores)				
	A	B	C	D
Gross Profit of the Bank	17,915.23	3,724.88	727.71	87.91
Less: Income from H.O Departments*	4,490.85	443.91	79.45	27.89
Gross Profit from Branch Banking Operations*	13,424.38	3,280.97	648.26	60.02
Total Business	1,284,576.33	198,930.88	59,291.00	8,164.87
% of GP from Branch Banking Operations to Total Business	1.05%	1.65%	1.09%	0.74%
Performance Materiality at the Component Level				
	Rs.	Rs.	Rs.	Rs.
Average Gross Profit from Branch Banking Operations for every Rs. 10 Crore of Business	1,045,043	1,649,302	1,093,353	735,100
@ 1%	10,450	16,493	10,934	7,351
@ 5%	52,252	82,465	54,668	36,755
@ 10%	104,504	164,930	109,335	73,510

\* For the purposes of this article income from treasury operations as per segment results has been considered as income from H.O. departments.

TABLE 4

Performance Materiality for Identification of NPA				
	A	B	C	D
Total Gross NPA (Rs. Crore)	15,589.00	897.77	161.04	64.43
Total Advances (Rs. Crore)	542,503.20	81,556.77	24,615.35	3,196.06
Percentage of Gross NPA to Total Advances	2.87%	1.10%	0.65%	2.02%
NPAs for every Rs. 1 Crore of Advances (Rs.)	287,353	110,079	65,423	201,592
Materiality at 1% level (Rs.)	2,874	1,101	654	2,016

TABLE 5

Apportionment of Total Materiality in respect of Provision for Tax				
	A	B	C	D
Provision for Current Tax (Rs. in Crore)	5,971.52	1,095.52	92.56	22.20
Equivalent Taxable Income @ 33.99% (Rs. in Crore)	17,568.46	3,223.07	272.32	65.31
Total Business of the Bank (Rs. in Crores)	1,284,576.33	198,930.88	59,291.00	8,164.87
Equivalent Taxable Income at the Branch for every 10 Crores of Business (Rs.)	1,367,646	1,620,194	459,286	799,931
Performance Materiality				
Errors in taxable Income for Every 10 Crore of Business arising out of error in Profit & Loss Account or while reporting in Form 3CD @ 1% (Rs.)	13,676	16,202	4,593	7,999



To express an unqualified opinion at the assigned degree of materiality, the branch auditors would have to carry out extensive substantive testing to be confident that all material errors in the financial statements of the branch have been discovered and corrected. Hence much more time has to be factored in the time schedule by the management of the banks for branch audit than is provided now.

# An Overview of Bank Branch Audit



A bank branch audit is an exercise which many chartered accountants are conducting over the years almost like a yearly ritual in the last fortnight of March and the first fortnight of April. Since the bank branch audit allotment happens usually in the second week of March, the preparatory work before even getting the audit and knowing which branches one would be auditing, could be started from the first week of March itself. This article attempts to guide the auditors to conduct an effective smart and intelligent bank audit exercise providing value and quality, given the paucity of time and resources at the disposal of the auditor.



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## Pre-Audit Planning

**Start Early:** Since the bank branch audit allotment happens usually in the second week of March, the preparatory work before even getting the audit and knowing which branches one would be auditing, could be started from the first week of March itself.

**Knowledge of Business:** The key at the start of any audit is to have a thorough knowledge of the subject matter under consideration which in this case is a complete knowledge of the banking business in India. This updated overview can be found in ICAI publication 'Guidance Note on Audit of Banks (2010 edition)'. One can also conduct a search on the Internet for the purpose. The auditor should also go through the Standards on Auditing issued by the ICAI especially on *Audit Sampling SA 530*, *Audit Documentation SA 230*, *Knowledge of Business SA 310*, *Using the work of another auditor SA 600*, *Audit Evidence SA 500*, *Audit Planning SA 300*, *Audit Materiality SA 320*, *Terms of Audit Engagement SA 210* and *Written Representations SA 580*.

**Audit Planning:** The next stage would be to plan the audit. One has to be absolutely clear on what he is supposed to do, how it is to be done and who will be doing it and how. A bank branch audit involves certifying the Balance Sheet and the Profit and Loss Account as stating a true and fair view, signing the Tax Audit Report, submitting the LFAR, Ghosh and Jilani Committee recommendations, Mandatory Certifications and Annexure to the Balance Sheet and the Profit and Loss account namely on account of Capital Adequacy, Asset Liability Management, Non-Performing Assets, SLR and CRR, DICGC, etc. Within the time constraints which may range from a maximum of 4 weeks to a minimum of a week, the auditor has to plan his time

**The next round of Audit Planning would start once you have actually got the bank audit assignment and you know which bank and branch is to be audited. Once you have got the appointment letter and are through with the acceptance and other connected audit formalities like issuance of Engagement letter, requisite declarations and indemnities to the concerned bank officials or the NOC with the previous Statutory auditor, comes the time to actually have a pre-audit meeting with the branch officials. The auditor should go through the bank closing instructions and other guidelines.**



considering the audit staff available with him so that necessary audit verification is done which will enable him to give his opinion.

If the auditor has conducted the bank branch audit previously or more so in the previous year, he should go through his audit working paper file and the statements certified by him to have a feel and refresh himself. The closing instructions given by the bank for finalisation of the accounts with the due dates could be revisited. The audit programme and an audit check list used previously could be the starting point for broadly drafting a similar audit programme and a check list for the current year.

**Identify Audit Staff:** The audit staff could be identified and they should be made familiar with the nuances of the bank audit by the Partner / Audit in-charge who could inform them about the manner in which such an audit is conducted, issues generally raised during the course of audit, documents to be obtained and the manner and extent of verification and reporting and certifying requirements. The staff should also be made to go through the previous year's audit files and the relevant ICAI Guidance Note. Any conceptual difficulties or queries of the audit staff should be clarified at this stage itself before even getting the actual audit so that one is conceptually clear and absolutely geared up to take the assignment as a challenge head on the moment it comes up.

The Guidance Note on Audit of Banks (2010 edition) is an updated, exhaustive, informative compilation on bank audit. Since it is updated till a particular date mentioned therein, all applicable RBI circulars after that date could be obtained from the RBI website – [www.rbi.org.in](http://www.rbi.org.in). Also the Master Circulars compiled by RBI till July could be accepted duly modified on account of further updates in these circulars.

Detailed checklists on bank branch audit would be available in the bank audit seminar compilations on this topic done by the various regional councils of the ICAI and the auditor could refer the same and fine-tune it to the requirement and the peculiarity of

his branch under audit.

The auditor could also attend the various seminars conducted by the ICAI to be conversant with the views of various speakers and resolve any queries if any or get a feedback on grey audit areas if any.

The details that would be required from the branch should be compiled at this stage itself, especially the written representations on management responsibility for the preparation of accounts, compiling details needed in the LFAR and in other areas where there is no independent audit trail.

### Planning Post Audit Allotment

The next round of Audit Planning would start once you have actually got the bank audit assignment and you know which bank and branch is to be audited. Once you have got the appointment letter and are thorough with the acceptance and other connected audit formalities like issuance of engagement letter, requisite declarations and indemnities to the concerned bank officials or the NOC with the previous statutory auditor, comes the time to actually have a pre-audit meeting with the branch officials. The auditor should go through the bank closing instructions and other guidelines, especially on the accounting policies followed by the bank so that he is thoroughly aware of what he is to do during the course of his audit and how he will do it before he meets the branch officials.

**Initial Audit Discussion:** The meeting with the branch officials, primarily with the branch head, should be preferably done with all audit staff already identified and trained. The talk with the branch head would be to get familiarised with the branch. Bank transactional volumes, level of advances and deposits, the main borrower accounts, the software system in operation, the key NPA accounts, the key areas of concerns, SWOT analysis, branch staff organisational structure, existing concurrent, stock or other internal audit arrangements could be briefly discussed at this meeting. All the branch staff should be introduced

with their roles and responsibilities. The auditor and his staff should individually meet all the staff separately and discuss with each one the issues already discussed with the branch head to not only corroborate that information but also for any additional information. The discussions with the branch head and staff should be documented in writing and form part of audit work papers and filed in the audit working paper file. At this stage, the auditor should obtain copies of the entire set of the previous year's signed accounts with Annexure, Certifications, Tax Audit Report and the LFAR, copy of the latest Trial Balance and the quarterly balance sheets and the Profit and Loss accounts. He should also obtain the concurrent audit reports, stock audit reports, internal audit reports, RBI inspection reports, system audit or any other audit reports if any. Apart from these documents, the auditor should also obtain key internal circulars, policies or guidelines of the bank, Schedule of Service Charges, delegation of financial powers of branch officials and MIS reports generated. A discussion with the concurrent audit officials, if there is such a prevalent system in the branch, could be done on that day itself. A key at this stage would be to finalise the staff seating arrangements, access to the bank's operational systems with a view access only and the liaisoning/co-ordinating branch officials. The date on which the various information/reports would be made available should also be finalised and if the same is not in sync with the closing instructions, this matter should be sorted out immediately. The audit details needed and the written representation required should be handed over to the branch head at this stage. It should be specifically made clear that the details/representations may vary after internal control assessments and course of audit based on audit observation and findings.

Based on these discussions with all the branch officials and concurrent auditors, the various audit reports and other documents obtained and information available, the auditor should draw up an audit programme which would be a modification of the audit programme drawn earlier. Due consideration will have to be given to deadlines and the availability of information from the branch, especially the MIS reports. If any deadlines are being breached due to delay in information availability from the branch, the same, if not sorted out with the branch head, should be communicated to the regional office well in advance so that the auditor does not get the flak for delay in signing the

accounts and submission of reports/certifications. The audit programme should be discussed with the branch head and his consent taken as the execution depends on his co-operation and making available the necessary information for the purposes of audit.

### Audit Execution

At the start of any audit, the testing of internal controls in operation in the branch is the primary requisite to validate the extent and manner of checking already determined in the audit programme. This can be done by obtaining the organisational chart and doing an activity mapping of all branch officials including outsourced officials. An understanding on the clarity of individual roles, responsibilities, authority and accountability as well as effective segregation of duties, financial powers, Maker Checker concept and the Control/Exception MIS Reports available, internal policies, rules, procedures and guidelines and awareness of the same by the branch officials, all aid in making an assessment of the internal control which would finally validate the audit programme for deployment of audit staff and the manner and extent of checking. Any weaknesses noticed at the internal control assessment stage should be formally communicated to the branch and may also suitably form a part of the final audit report/LFAR as the case may be. At this stage the audit programme drawn pre-audit and then modified post audit subsequently after discussions with the branch officials should be retested and conclusively finalised. The auditor must be aware of the various risks namely operational, market, financial, reputational, strategic, business, systemic, regulatory, etc. that could be faced by the bank. Further, any weakness in internal controls is an open invitation to frauds and the auditor should have a professional scepticism that frauds may occur.

**Monitoring:** The audit in-charge should monitor the audit progress on an ongoing basis preferably taking stock at the end of every day whether things are as per the plan. The LFAR should be updated on an ongoing basis for the questions already verified. Any deviations needing re-allocation of audit resources should be done immediately in view of the deadlines for issuance of the reports/certifications.

Execution remains a key despite all the effective planning and scheduling. All necessary details required for the audit are readily available from the MIS reports that a branch generates. The key is

knowing what MIS reports are being generated and using the same effectively for the purposes of audit. The auditor has to stick to his audit programme. If any delays are occurring during the course of audit either due to control weaknesses, lack of availability of information reports or non co-operation by any officials, the same should be sorted out immediately as not to affect/alter the eventual deadlines or appropriately communicated to the regional authorities. Audit issues, if any, raised during the course of audit should be clarified immediately with the concerned officials and should not be kept for resolution at the end of audit. In case of doubts, the auditor could also liaison with the central statutory auditors.

**Disclaimers:** The auditor is reporting on the accounts for the entire year whereas he is actually present in the branch premises only in the last 2 weeks of March and the first 2 weeks of April at the most. The primary disclaimer in the LFAR is where he has to report on the system in operation in the branch during the year. Since he was not conducting the audit for almost the entire year, his observations will be based only on the written representations obtained or his observations during his course of audit and that has to be explicitly brought out. Due to the volume of transactions and the paucity of time, the auditor will be primarily conducting a test check based on his process reviews and internal control assessments and the extent and manner of his audit sampling methodology has also to be explicitly stated in the LFAR. Reliance, if any, placed on the reports of the concurrent audit reports, stock audit and other internal or RBI audit reports if any, should be brought out. The fact that he has not conducted a system audit in-depth and has relied on the accuracy of the system and the MIS reports generated therein based on his test checking should be brought out. Constraints, if any, on availability of information, especially the latest updated internal circulars and guidelines, access to the system and audit staff seating arrangement should be reported. The same should be done for other specific issues which increase audit liability without commensurate availability of reliable audit evidence that would come in the way of the auditor stating a true and fair view of the accounts or

expressing his opinion.

**To recap, the disclaimers would be in the nature of:**

- a) Days actually spent on audit
- b) Written representations not obtained
- c) Information and explanations not received
- d) Use of audit sampling
- e) Reliance on external auditors
- f) Reliance on the accuracy of the system
- g) Other disclaimers increasing audit liability without commensurate availability of audit evidence.

**Specific issues to be noted –**

- a) Verification of compliance of MOC passed by previous year's Statutory Auditor.
- b) Analytical review of the quarterly balance sheets and the profit and loss accounts could be done for any abnormal deviations.
- c) Explanations for Variances (YOY) of more than 20% could be obtained in writing.
- d) Debit balances in income account and credit balances in expense accounts or liability accounts showing a debit balance and an asset account showing a credit balance should be enquired.
- e) Independent bank balance confirmation to be obtained.
- f) Detailed proofing of major balance sheet accounts should be obtained.
- g) Ledger scrutiny of suspense accounts should be done.
- h) Bank reconciliations and inter-branch reconciliations should be scrutinised. If any pipeline entries passed subsequently need to be given effect to by way of a MOC (Memorandum of Change), the same should be given effect.
- i) Process of physical verification and numbering of fixed assets.
- j) Identification of NPA accounts, classification and provision thereon is a key as any diversion between audit classification as per audited accounts and that observed by RBI auditors is viewed negatively and may face censure.

In case of NPA classification, attention has to be given to the upgrades or the accounts that have been removed from NPA status vis-a-vis previous year and the date of classification of NPA which in case of existing NPA from the

**At the start of any audit, the testing of internal controls in operation in the branch is the primary requisite to validate the extent and manner of checking already determined in the audit programme. This can be done by obtaining the organisational chart and doing an activity mapping of all branch officials including outsourced officials.**



**The auditor is reporting on the accounts for the entire year whereas he is actually present in the branch premises only in the last 2 weeks of March and the first 2 weeks of April at the most. The primary disclaimer in the LFAR is where he has to report on the system in operation in the branch during the year. Since he was not conducting the audit for almost the entire year, his observations will be based only on the written representations obtained or his observations during his course of audit and that has to be explicitly brought out.**

previous year, the date as certified by the previous statutory auditor should be accepted as correct.

- k) For arriving at the valuation of the security, a consistent acceptance of either the net realisable value, the distress value or the market value should be arrived at. In case of Balance Sheet Fixed Assets, a uniform rate of depreciation should be taken.
- l) Regularisation of NPA account by a solitary cash entry close to the year-end should be justified for the genuineness by obtaining the necessary comfort letter.

An account once classified as an NPA can be upgraded only on clearance of all overdue as on the date of the upgradation.

Auditors should also be careful that no ever greening of accounts is done either by unwarranted restructuring or sanction of additional limits.

An important concept to be noted is that the account becomes NPA only when it is overdue for more than 90 days and overdue concept is to be strictly reckoned from the due date fixed by the bank for repayment.

NPA is an account which ceases to earn income for the Bank. The identification criteria is objective and explicitly laid down in the Master Circular. An account may have sufficient security and there may be no eventual loss to the bank but if the criteria laid down for identification are met, the account will have to be classified as NPA. Conversely, an account may eventually cause a loss to the bank but if the 90-day criteria is not breached, the classification need not be pre-poned and the asset could be classified as standard with suitable adverse comments in the LFAR regarding the conduct and the eventual possibility of it becoming an NPA.

- m) In case of attestation of the annexure to the balance sheet, the source for compilation of the data must be tested for accuracy and an

independent test check done apart from corroboration from other statements and records.

- n) The LFAR should be compiled alongside the main audit report and should never be commenced after completion and signing the main audit report. The answers should be specific, clear, unambiguous and the rationale behind the answers should be specifically stated instead of just answering as YES or NO. The LFAR should not be construed as a substitute for the main audit report and any entries, if material and necessitating a qualification in the main accounts or MOC, should be routed through the main audit report only and not through the LFAR. The LFAR is not an exhaustive questionnaire and any other areas wherein there is any issue should also be mentioned therein. For specialised branches, there are some additional questions to be answered and these should be reported wherever applicable.

The LFAR should specifically comment on the KYC compliance and the Disaster Recovery Policy and the Business Continuity Planning. Other areas which could be considered for reporting are the outsourcing policy, mobile and Internet banking policy, data retention and security policy, physical security, e-mail policy, fraud & risk policy. The LFAR is the main document wherein the auditor can add value by identifying errors and weaknesses, providing remedies and solutions more so at the operating level. This can also serve as a useful brand ambassador of audit quality.

- o) The key would be to prevent the error identified from the transactional checking from occurring again by understanding the defect in the process and setting it right rather than mere rectification of the error. Audit should be preventive in spirit and the cure should be from the roots so that it never recurs. The auditor should be a solution provider and not just a problem identifier.
- p) With the financial crisis that prevailed in 2008

globally, banking has become more complex and subject to even more risks. A brief overview of the risk assessment and the risk culture prevalent in the branch can be commented upon in light of the assessment of the internal controls, accuracy of MIS report and transactional testing. The auditor could also discuss with the branch head and key branch officials on the risks identified by them and how the same are measured, controlled, monitored and mitigated. Any lacuna in the risk assessment process should be brought out as audit is now increasingly looked upon as a risk assurance provider also.

- q) The Ghosh Committee recommendations on frauds and malpractices in banks issued in June 1992 and the Jilani Committee recommendations on Internal control and audit/ inspection system in banks issued in February 1995 were made mandatory to be reported from November 1996. Though some of these committee recommendations are outdated and not applicable in view of total computerisation and evolving banking practices, these still need to be verified and reported.

The auditor should note whether the bank is really in compliance with the Jilani committee recommendations regarding rating of branches based on the inspection reports and whether the bank has an updated manual of instructions in place for auditors/inspectors.

The auditor should also note whether the following recommendations of the Ghosh committee are applicable and complied with by branches, especially regarding –

- Micro filming of records, books and vouchers
- Desk cards to be prepared for all staff
- Safe custody and access to vouchers with orders of the manager
- Specimen signature of inoperative accounts in custody of the manager
- Return from staff members regarding submission of financial information
- Use of paper for writing cheques/ drafts to be of such material that any alterations therein are visible to the naked eye
- Use of pinpoint typewriters or reverse carbon while writing drafts/ mail transfers

In case of any issues, the responses of the Branch head must be obtained and incorporated in the LFAR or the Ghosh/Jilani Committee report recommendations certifications. A discussion certificate of having discussed the

LFAR/ Ghosh-Jilani reports and Written Representations obtained could be either submitted alongside these reports or retained as a work paper. This will prevent any disputes regarding the nature of queries raised later on.

- r) In case of any divergence on any MOC which the branch head refuses to acknowledge and sign, the same can be submitted without the branch head signature or the main audit report could be qualified if the amount is material and so warrants. An alternate mention could also be made in the LFAR and brought to the notice of the central statutory auditors.
- s) The Tax Audit report also has to be signed in accordance with the provisions of section 44AB of the Income-tax Act, 1961 wherein the auditor has to certify form 3CA and Form 3CD. Attention should be given whether tax has been deducted at source at the correct rates and paid in the government account in time, whether proper compliance of the provisions of section 43B is done and whether proper treatment is given to prior period items.

To recap, the key in a bank branch audit is –

1. An early start
2. Knowledge of banking business
3. Proper planning with a clear focus and vision knowing what is to be done, how, by whom, when and why and effective monitoring
4. Effective discussions with concerned branch officials
5. Testing of internal controls
6. Clarity on risks faced by the branch
7. Maintaining proper work papers
8. Effective audit sampling
9. Skilful use of MIS reports
10. Use of written representations
11. Obtaining Discussion Certificate from branch head
12. Ensuring compliance with RBI circulars especially regarding NPA identification, classification and provisioning
13. Detailed Balance Sheet and Profit and Loss scrutiny
14. Clear and specific replies to the questions in the LFAR and Ghosh/Jilani Committee reports, mandatory certifications and signing off the tax audit report
15. Ensuring adherence to the deadlines
16. Giving appropriate disclaimers and issuing MOC and qualifications wherever warranted. ■

# Conducting Statutory Branch Audit in CBS Environment: An Approach



Ensuring quality as well as completion of task within set deadlines is a real challenge today for statutory branch auditors of a bank. This challenge gets tougher when returns / statements to be audited or supporting back up papers are not found ready for auditing at branches. This makes paramount for auditors to deploy an approach that prepares well themselves as well as the branches to get the entire branch audit done in an effective and timely fashion. This article offers a format of staged approach encompassing five consecutive stages. Article emphasizes on orderly and coherent execution of all audit procedures for - financial statements audit, related verifications, LFAR, tax audit and special purpose certifications- minimising probabilities



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**E**nsuring quality and punctuality is a real challenge today for statutory branch auditors of a bank. This challenge gets tougher with the management's deadlines to submit the reports, and most often when the returns/statements to be audited or supporting back-up papers are not found ready for auditing at branches. Many auditors, under pressure of the management's deadlines, tend to approach auditing frantically, omitting/duplicating the many audit procedures; resulting into poor quality audit or completion delays.

This makes paramount for auditors to deploy an approach that prepares themselves as well as the branches to get the entire branch audit done in an effective and timely fashion. The risk-focused planning and systematic management of audit procedures are key to help overcome the situation.

The statutory auditors may adopt a format of staged approach encompassing five consecutive stages. These five stages are:

- I. Accepting the Audit
- II. Planning the Audit
- III. Performing the Preliminary Audit
- IV. Performing the Final Audit
- V. Reporting the Audit

According to Para 8(a) of SA-300 revised "Planning an Audit of Financial Statements", "The auditor shall develop an audit plan that shall include a description of the nature, timing and extent of planned risk assessment procedures as determined under SA-315, *"Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment."* On first hand, this understanding could be gained by collecting the sketchy profile of the branch, which will provide key information on the nature, size, products, operations and technological environment of the branch.



### Stage-I: Accepting the Audit

As soon as the letter of offer for statutory branch audit is received, first and foremost, auditors should communicate to the previous auditors in terms of code of ethics and should issue the audit engagement letter to the bank in terms of SA-210 (Revised) *"Agreeing the Terms of Audit Engagements"*. Then, auditors should take following steps:

#### 1. Obtaining information on policies, systems and procedures, guidelines and instructions of the controlling authorities of the bank:

Having accepted the assignment, the first step auditors should take, is to collect following key information from the management:

- i. Accounting policies and changes in accounting policies during the year,
- ii. Closing guidelines/instructions,
- iii. Closing activities taken care centrally at data centre/HO/controllers and the activities required to be carried out at branches e.g., manual adjustments, etc.
- iv. Software applications used for financial reporting and Audit Exception Reports generated at branches.
- v. Various policies, systems and procedures, guidelines and instructions of the controlling authorities, compliance of which is required to be commented in LFAR. These can be recovery policy, system of obtaining stock audit reports, and procedure regarding verification of securities, etc.

#### 2. Getting Branches Prepared

It would always yield obvious benefit to the auditors to obtain written confirmation of readiness of records/information and exception/analytical reports generally required for auditing, before proceeding for on-site auditing at branch. Some of the useful audit exception/analytical reports generally available in CBS environment are illustrated in Appendix-I

Now, having done the above routine but must-do communication work, auditors should start planning the audit.

### Stage-II: Planning the Audit

To develop an overall audit plan, following steps of auditors as planned risk assessment procedures could help identifying and assessing the risks of material misstatements:

#### 1. Understanding the Entity and its Environment:

According to Para 8(a) of SA-300 revised "Planning an Audit of Financial Statements", "The auditor shall develop an audit plan that shall include a description of the nature, timing and extent of planned risk assessment procedures as determined under SA-315, *"Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment."*

At first hand, this understanding could be gained by collecting the sketchy profile of the branch, which will provide key information on the nature, size, products, operations and technological environment of the branch.

Collecting information on general internal control environment, through a questionnaire, would help getting a first-hand idea of systems and procedures followed and also of the various information/accounting records maintained at branch.

Formats of questionnaires on branch profile and on general internal control environment, suggested by this author are given in March, 2008 issue of the Journal.

Suggestively, this preparatory piece of planning should be taken up well before on-site visit to the branches, as the understanding gained through these questionnaires would work as good input for constitution of audit-team, time-budgeting, travel plan, and other planning work.

#### 2. Carrying out Preliminary Analytical Reviews

In accordance with the guidance provided in SA-520 *"Analytical Procedures"*, following analytical reviews carried out by the auditors as preliminary risk

assessment procedures, would help identifying the risk of material misstatements.

- i. Comparing following trends and ratios of current year with that of previous year
  - a. Operating profit to total incomes (%)
  - b. Net profit to total incomes (%)
  - c. Operating expenses to total incomes (%)
  - d. Non-interest income to operating profit (%)
  - e. Deposits
  - f. Advances
  - g. NPA
- ii. Comparing near quarter-end figures of Deposits and Advances
- iii. Carrying out Correlations:

Correlations would help identifying various errors/inconsistencies such as,

- Correlation of profit and loss items with balance sheet items would reveal accounting errors/inconsistencies. For instance, repair expenditures capitalised in premises account, while rent paid account shown in profit and loss account.
- Correlating non-financial events/information with financial events/information would help reveal errors of omissions and inconsistencies. For instance, commission on government business not recognised while information on government business obtained.

Thus, this little amount of analysis done at planning stage would help identifying many apparent errors/inconsistencies. Auditors should obtain branch management's written explanations on abnormal/significant variances and should examine such explanations for their reliability. Sometimes unexplained/abnormal variances could be indications of possible misstatements/ window dressing. For instance, sudden spurt/ downfall in near quarter-end deposits and advances figures could be a result of transfer entries from unutilised credit limits to deposit accounts before quarter end and *vice versa* after quarter end.

### 3. Using the Work of Internal Auditors

Use of internal auditors' work at planning stage itself would help in a good way. Internal auditors' work in following areas could be useful while designing external audit procedures:

- i. Non-availability of reconciliations / persisting un-reconciled differences in subsidiary ledger balances.
- ii. Non-verification at stipulated periodicity/ differences persisting in cash balances,

sensitive stationeries and fixed assets.

- iii. Non-verification / diminution in value of securities charged to the bank.
- iv. Non-compliances of RBI's IRAC norms.
- v. Non-compliances of TDS and other tax laws, government directives and regulations.
- vi. Events/information resulting into contingent liabilities/provisions.

It is suggested that auditors obtain in advance the written categorical information on different internal audits/interim reviews of financial statements conducted and reports received during the year including Special/Flash Reports and also the confirmation of significant deficiencies persisting at year-end.

However, as a word of care, para 11 of SA-610 (Revised) states "In order for the external auditor to use the specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes."

Thus, at the end of above hard work of planning, auditors should commence performing the audit.

### Stage-III: Performing the Preliminary Audit

Before applying the final audit procedures, auditors should spend some time on taking few preliminary steps, such as

1. To determine that authenticated account balances reports on all subsidiary ledgers reconciled with GL control accounts, are held. Auditors, instead of assuming the accuracy of balancing and reconciliation as granted in CBS environment, should have a



Once the preliminary assurance about the reconciliation/agreement of financial statements' balances with underlying records is obtained, auditors should design substantive procedures for different items. To plan the nature and extent of final audit procedures, reading of para 20 of SA-330 *Auditor's Responses to the Assessed Risks*, would be worthwhile. Para 20 states "Irrespective of the assessed risk of material misstatements, the auditor shall design and perform substantive procedures for each class of transactions, account balances, and disclosure."

cursory look on individual account balances reports which would help identifying anomalies crept in, e.g., un-located/un-reconciled balances lying therein, and ledger accounts opened in inappropriate account heads/GL subhead, etc.

2. To ascertain for any error/inconsistency in balancing by scrutinising the GL error report. Comparing balance sheet of current year with that of previous year would help ascertaining whether grouping of all sub heads into balance sheet heads is appropriate and consistent.

3. Carrying out analysis of variance for incomes and expenditures with that of previous year, would help identifying the accounts to be examined in detail or the immaterial amounts for which no further procedure is required.

This preliminary work would help satisfying about the reconciliation of primary and subsidiary ledgers and cross verification of records. Now, auditors should start performing final audit.

#### Stage- IV: Performing the Final Audit

Once the preliminary assurance about the reconciliation/agreement of financial statements' balances with underlying records is obtained, auditors should design substantive procedures for different items.

To plan the nature and extent of final audit procedures, reading of para 20 of SA-330 *Auditor's Responses to the Assessed Risks*, would be worthwhile.

Para 20 states "Irrespective of the assessed risk of material misstatements, the auditor shall design and perform substantive procedures for each class of transactions, account balances, and disclosure."

Here are suggested audit procedures in respect of few of the key items of financial statements, auditors could fashion their approach for substantive procedures:

##### 1. Advances Returns and IRAC Norms

Today, auditors struggle with the best way to audit the advances returns and IRAC norms. It is learnt that the procedures currently followed at branches are not systematic and are rather erratic. Generally, system generated asset classification reports are not used for financial reporting purposes. Instead, manual modifications are carried out in the system generated reports. Basis of identification of NPA / manual modifications are not documented generally. Also, at most times, in advances returns, key information e.g., dates of review/renewal of limits, inspections, renewal of loan documents and insurance are not found checked for correctness.

In such situations, validating inputs of all accounts from source documents is not an option for auditors allowed by the time budget and also not a viable way of auditing. Following are few steps/audit considerations that could help designing an approach for this verification:

- i. To check the log of changes made in system generated asset classification and to determine whether all manual alterations in system generated reports are duly authenticated for correctness.
- ii. To check from the periodical returns on potential NPA and system generated potential NPA reports whether these have been considered while identifying NPAs.
- iii. To determine that borrower level limit has been linked to all accounts, in all NPA accounts.
- iv. To determine by obtaining the reconciliation of NPA with Interest Not Collected Account and Unrealised Interest of Previous Year that uncollected interest income has been derecognised in all NPA accounts.

##### 2. Office Accounts

At year-end, old outstanding balances in office accounts e.g., sundries, suspense, intermediary accounts, etc. are zeroised generally. Auditors, instead of skipping their verification altogether, should check the periodical control returns of office accounts, especially of previous quarter, and should scrutinize the full ledger accounts to examine the correctness of pruning of entries at year end. Obtaining age-wise and nature-wise break up e.g., recoverable, revenue, other suspense, etc. will help verifying the appropriateness of their pruning.

##### 3. Incomes and Expenditures

Besides applying normal analytics e.g., comparison and correlations, etc. and obtaining representations by management on abnormal variances, auditors should scrutinize the system-generated interest applied/failed reports also to examine any material misstatement. Circumstantial evidences such as substantial reduction in non-interest incomes due to RTGS business during the year should also be considered before reaching any audit conclusion.

##### 4. Material Journal Entries/Year-end Adjustments

Comparing pre-closing and post-closing trial balance, and comparing adjustment account with that of previous year, would also help identifying any apparent omission/discrepancies. Auditors should check and determine one by one that policy/guidelines of the bank, regarding material journal entries/adjustments, have been complied with

meticulously, e.g., amortisation of incomes/expenses, etc.

Objective of this article has been to sketch an audit approach, instead of suggesting the detailed audit procedures for all items. Auditors should design and apply audit procedures for different items.

Now, having performed all audit procedures, auditors should take up the reporting work.

### Stage-V: Reporting the Audit

Finally, having consolidated all the findings, auditors should review these findings and should assess the impact of significant audit findings on opinion. Having assessed the impact, if matter affects opinion, auditors should consider issuing report as per guidance available in SA-700 i.e., qualified, disclaimer, and adverse. If matter does not affect opinion, auditor should assess whether matter requires emphasis. Then, audit report without qualifications with suitable modifications, could be issued.

However, in practical audit situations, auditors may come across significant uncertainties, where financial impact of matter emphasised, is not ascertainable. In such situations, auditors, having obtained the branch management's written explanations on such matter/estimate of impact, should examine the management's explanations and should report appropriately, e.g. in main report or in LFAR with sufficient details, apprehending central auditors/senior management to assess the significance/impact. For instance, dispute on enhanced lease rent, lease deed of branch premises not got registered and notice from revenue authorities imposing tax and penalties.

### Staged Approach Yields Many Benefits

By splitting the entire auditing process into five consecutive stages, article lays stress on orderly and coherent execution of audit procedures, minimising probabilities of lapses and duplication of work. Article sketches a risk-focused systematic approach to plan, perform and report the audit. It would help managing the time budget, besides documenting the audit simultaneously, eventually resulting into a quality audit in timely fashion. Overall, article could be a starting point for developing an audit approach and could work as beginners' guide.

### Appendix-I

*Some useful Audit Exception / Analytical Reports generally available in CBS environment*

#### For Balance Sheet and Profit and Loss Account Audit

1. Age-wise and nature (head)-wise classification of all office accounts.
2. Advances disbursed by transferring to deposit accounts.
3. Abnormal transactions in term deposit accounts.
4. GL error report.
5. Accounts having minimum interest rate pegged.
6. Interest applied/failed report for deposits.
7. Interest applied/failed report for advances.
8. Loan accounts with Zero interest rate.

#### For LFAR Procedures

1. Overdue stock/book-debts/QIS statements.
2. Overdue reviews/renewals of credit limits.
3. Expired insurances/under-insurances of securities.
4. Overdue inspection of securities.
5. Overdue renewal of loan documents.
6. Overdue valuations of fixed assets charged in NPA.
7. TDRs where lien has been lifted.
8. Loans against TDR where lien Not marked.
9. Cash balance above the cash retention limit.
10. Accounts having sanction limit exceeding rupees five crore.

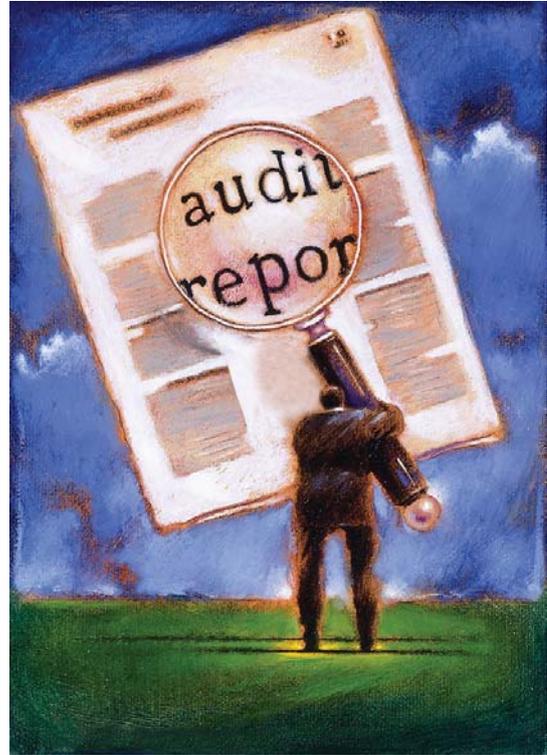
#### For IRAC Compliance Audit

1. Accounts where moratorium period expired and interest flag "N".
2. Sub standard accounts restructured during the year.
3. Standard accounts rescheduled during the year.
4. Transaction turnover in CC accounts.
5. Report on overdue installments and interest in loan accounts.
6. Accounts where value of securities is less than drawing power.
7. Accounts out of order for more than 90 days.
8. Sub-standard NPA upgraded during the year.

#### For Tax Audit

1. Interest paid on term deposit above the exemption limit.
2. TDS not remitted within seven days from the last day of previous month.

# Long Form Audit Report in Case of Bank Branches



Auditors are commonly believed to be eyes and ears for banks. Branch Statutory Auditors have been entrusted with the responsibility by the Regulators to provide information on issues given in Long Form Audit Report (LFAR). In this regard, proper control on processes has assumed high importance particularly after migration of banking on computers. LFAR is a vital tool available to auditors through which they can comment on Balance Sheet, Profit & Loss account, Prudential norms, process lapses in operations and other issues relating to Branch Statutory Audit. The LFAR should be updated on an ongoing basis for the questions already verified. This article attempts to make auditors understand the importance and coverage of LFAR in computerised banking.



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**B**ranch auditors have to answer a detailed questionnaire formulated by RBI. Most of the questions in LFAR contain following lines:

- 1) Does the branch generally carry or comply...
- 2) In the cases examined by you, have you come across instances...
- 3) Verification on test check basis...

Hence, it becomes very important for auditor to keep the record of all samples verified for framing the opinion on the different processes in the questionnaire.

<b>I ASSETS</b>	
<b>1 Cash</b>	
a) Does the branch generally carry cash balances, which vary significantly from the limits fixed by the controlling authorities of the Bank? Whether excess balances have been reported to the controlling authorities of the Bank?	<ul style="list-style-type: none"> <li>The cash retention limit of branch should be obtained by the Auditor and he should review the cash records and then comment, if cash balance generally exceeds significantly the retention limit. He should verify that instances of excess cash beyond retention limit are being regularly reported in returns to HO.</li> <li>Obtain cash limit fixed for ATM machines in case ATM is being operated by branch. Generally, sometimes during festival season or continuous holidays, cash is fed more than limit to serve customers. Auditor should verify, whether excess cash beyond limit has been intimated to higher authorities.</li> </ul>
b) Does the branch hold adequate insurance cover for cash on hand and cash-in-transit?	<ul style="list-style-type: none"> <li>The branch should be asked as to who is getting the cash insured. In case it is done by HO, a management representation should be obtained and commented upon accordingly.</li> <li>In case insurance cover details are available at branch, auditor should verify, whether branch holds adequate insurance cover of cash on hand, cash in ATM, and cash-in-transit. He should verify insurance cover in force.</li> <li>Cash in transit generally includes the movement of cash between currency chest and branch, one branch to another branch/EC, cash movement for door step banking facility to clients, etc.</li> </ul>
c) Is cash maintained in effective joint custody of two or more Officials, as per the instructions of the controlling authorities of the Bank?	<ul style="list-style-type: none"> <li>Auditor should obtain the prescribed guidelines from branch with regard to custody of vault cash/ATM cash and comments in case of deviation.</li> <li>Cash vault/ATM machines can be opened by joint custodians. Auditor should physically verify the vault cash/ATM Cash and observe that vault/ATM machines are being opened by joint custodians as prescribed only. Ensure that custody of keys of vault/ATM machines should be with the staff as mentioned in key register of the branch.</li> <li>Verify from records, whether duplicate keys of cash vault and ATM machines are deposited with other branches as prescribed.</li> </ul>
d) Have the cash balances at the branch been checked at periodic intervals as per the procedure prescribed by the controlling authorities of the Bank?	<ul style="list-style-type: none"> <li>The prescribed procedure in the bank for periodical verification of cash should be obtained and it should be ensured that it is being strictly adhered to. If, there is any deviation from the prescribed process, it should be reported.</li> <li>In every bank generally joint custodians are supposed to verify cash every day at the time of cash closing and to sign the cash records evidencing the same. Similarly for ATM machines, cash is verified daily at the time of feeding of cash in machine by joint custodians.</li> <li>In some banks, there is also prescribed procedure for monthly verification of cash by officer other than custodians. Ensure same has been conducted and evidenced on records.</li> </ul>
<b>FOREIGN CURRENCY—</b> All above points are applicable to foreign currency also.	
<b>2 Balances with Reserve Bank of India, State Bank of India and other banks</b>	
a) Were balance confirmation certificates obtained in respect of outstanding balances as at the year-end and whether the aforesaid balances have been reconciled? If not, the nature and extent of differences should be reported.	<ul style="list-style-type: none"> <li>Balance confirmation at year end should be obtained. If it is not received, the same should be commented with name of bank and outstanding balance pending for confirmation.</li> <li>It should be verified as to whether reconciliation of balance as per confirmation obtained at year end has been done with books of account maintained by</li> </ul>

	<p>bank. If not reconciled, same should be commented upon.</p> <ul style="list-style-type: none"> <li>• Comment on nature of entries and extent of differences if any.</li> </ul>
b) The observation on the reconciliation statements may be reported in the following manner:	
i. Cash transactions remaining unresponded (give details):	Cash deposited at or taken from SBI/RBI/other bank and entries are pending in reconciliation unresponded. Auditor should obtain and furnish the details about such unresponded entries along with reasons.
ii. Revenue items requiring adjustments/write-off (give details):	<ul style="list-style-type: none"> <li>• It should be commented as to whether any 'charges' entry is pending for adjustment in reconciliation or any entry needs to be written off as on 31-3-2010.</li> </ul> <p><b>Example</b> — Sometimes, clearing house charges interest for overdrawn amount are debited by clearing house and same are not accounted for at branch during the year.</p> <p><b>Example</b> — There are some entries debited by other banks, which are not accepted by branch due to some dispute.</p> <ul style="list-style-type: none"> <li>• If auditor thinks that charges should have been debited to expenses account or amount lying in reconciliation is not recoverable and needs provision, such entries should be commented upon in LFAR. Such cases should also be recommended in Memorandum of Changes.</li> </ul>
iii. Old outstanding balances remaining unexplained/unadjusted. Give details for:	From reconciliation, auditor should find out old unexplained/unadjusted entries and give the details of old entries along with reasons.
a) Outstanding between six months to one year	<b>Example</b> — Differences of inward and outward clearing transactions with clearing house not identified and lying in reconciliation.
b) One year and above.	If it is felt that in reconciliation, any entry needs special attention of the management, same should be reported. Instances are:
c) In case, any item deserves special attention of the management, the same may be reported.	<b>Example</b> — Inward clearing cheques received from clearing house are lying in reconciliation instead of debiting to operating account. There is possibility that limit account/SB/current A/c were out of funds and would have become NPA in case of debit to these accounts on the date of payment to clearing house. Auditor should look into such cases and take the decision.
	<b>Example</b> — In case, branch is not obtaining balance confirmation and not reconciling periodically the bank accounts as prescribed, such default should be commented.
<b>3 Money at Call and Short Notice</b>	
Has the branch kept money-at-call and short notice during the year? If so, whether instructions/guidelines, if any, laid down by Controlling Authorities of the Bank has been complied with?	<ul style="list-style-type: none"> <li>• Go through instructions received from HO with regard to amount deposited.</li> <li>• Verify whether instructions/guidelines laid down by the controlling authority for money at call and short notice have been complied by branch. If there is any deviation, same should be commented upon.</li> <li>• In case of unauthorised deposits including those made in excess of the authorised limits arising in this account should be reported with name of bank, account and other details.</li> </ul>
<b>4 Investments</b>	
<b>A For Branches in India</b>	Obtain NIL certificate from branch and comment accordingly if branch does not hold any investments. In case branch is having investment certificates, a certificate should be obtained from the branch giving details of all investments held by branch.
a) Are there any investments held by the branches on behalf of Head Office/other offices of the Bank? If so, whether these have been made available for physical verification or evidences have been produced with regard to the same where these are not in possession of the branch?	<ul style="list-style-type: none"> <li>• Physical verification of investment certificates with the investment register should be done.</li> <li>• If any certificate is not available, verify evidence for not keeping the same in possession.</li> <li>• Verify acknowledgment if certificates are sent for realisation.</li> </ul>

	<ul style="list-style-type: none"> <li>In case, neither certificates have been made available for physical verification nor evidences as mentioned above are available, auditor should comment for such certificates.</li> </ul>
b) Whether any amounts received as income on such investments have been reported to the Head Office?	The system of reporting the receipt of income on the investment held on behalf of corporate office should be verified and it should be ensured in all the cases that income is received on due date and reported to HO.
c) In respect of investments held by the branches on behalf of Head Office / other offices of the bank whether any income is accrued /received and recognised as income of the branch contrary to the instructions of the controlling authorities of the Bank?	Instructions from Corporate office regarding accounting of income on investments should be verified. Generally, instructions are, income received on investments should be sent to HO through IBR and same should be recognised as income at HO to have better control. Comment in case, income is accrued/received and recognised as income of the branch, contrary to the instructions of controlling authorities of the branch.
d) Whether there are any matured or overdue investments, which have not been encashed? If so, give details.	The Investment register maintained at the branch should be verified and auditor should comment the cases where investments have matured or overdue and same have not been encashed. Give details of such investments.
e) Whether the Guidelines of the Reserve Bank of India regarding Transactions in Securities have been complied with?	For item (e) and (f)—Generally these activities are being done at corporate office/specialised branches. If being done at branch, obtain the guidelines issued by corporate office/ RBI for transactions in securities and ensure whether same are complied with. In case of any deviation same should be commented upon.
f) Whether the Guidelines of the Reserve Bank of India regarding Valuation of Investments have been complied with?	Corporate office guidelines for valuation of investment should be obtained. A statement showing the basis of valuation of investment should also be obtained from bank management. If statement is not received, it should be commented upon accordingly in report. In case valuation is not as per guidelines, impact of the same on profit should be reported along with deviation details.
<b>B For Branches Outside India</b>	Normally the central/head office of the bank deals with these investments. Hence not discussed in this article.
<b>5 Advances</b>	
<b>a) Credit Appraisal</b>	
In your opinion, has the branch generally complied with the procedures/instructions of controlling authorities of the bank regarding loan applications, preparation of proposals for grant/ renewal of advances, enhancement of limits, etc., including adequate appraisal documentation in respect thereof.	Based on verification of documents relating to loans, opinion should be formed as to whether branch has complied with procedures/ instructions issued by Head Office on following key issues. If there is any deviation same should be commented upon. <b>Loan Application</b> — Auditor should examine whether appropriate forms as prescribed by corporate office are being obtained according to nature of loan/limit. <b>Preparation of Proposals</b> — Proposals for grant/renewal of advances, enhancement of limits are being recommended after due consideration of all relevant factors like latest financial statement, past dealings, repayments capacity of the parties. Auditor should verify, whether in appraisal, important informations for the borrower have been commented by branch officials. Instances of important information are given below: <ul style="list-style-type: none"> <li>Unit is functioning properly.</li> <li>All primary and collateral securities are in order and fully insured.</li> <li>Borrower has not deviated from terms and conditions of sanction.</li> <li>End use of loan is being done for the purpose for which it was disbursed.</li> <li>Borrower is repaying as per schedule without any default.</li> <li>Operation of account is satisfactory.</li> <li>There is no major difference between audited financial data and projections submitted earlier.</li> </ul> <b>Documentation</b> — It should be verified as to whether all legal documents as prescribed in bank and as per sanction

	have been taken, executed and completely filled. All legal formalities relating to documentation has been completed like stamping as applicable to respective states.
<b>b) Sanctioning/Disbursement</b>	
i) In the cases examined by you, have you come across instances of credit facilities having been sanctioned beyond the delegated authority or limit fixed for the branch? Are such cases promptly reported to higher authorities?	Pertaining to all the cases examined by auditor, it should be verified as to whether the credit facilities were sanctioned beyond limits defined as per delegated financial powers (DFP) and same have been reported to higher authority as per prescribed procedure. In case of non-reporting, auditor should report the same. Following are instances which need reporting if exceed DFP: <ul style="list-style-type: none"> <li>• Loan sanctioned.</li> <li>• Operation permitted above sanctioned limits.</li> <li>• Temporary overdraft.</li> <li>• Withdrawal permitted against cheque pending in clearing.</li> <li>• Cheques/bills purchased.</li> <li>• Any other credit facility permitted.</li> </ul>
ii) In the cases examined by you, have you come across instances where advances have been disbursed without complying with the terms and conditions of the sanction? If so, give details of such cases.	If auditor finds an instance where loan has been disbursed without complying the terms and conditions mentioned in sanction letter, the same should be reported. Few such instances are: <ul style="list-style-type: none"> <li>• Loan disbursed without creating EM on property.</li> <li>• Loan disbursed without obtaining personal guarantees of directors.</li> <li>• Loan disbursed without completing the requirements mentioned in legal report of lawyer relating to property kept under EM.</li> </ul>
<b>c) Documentation</b>	
i) In the cases examined by you, have you come across instances of credit facilities released by the branch without execution of all the necessary documents? If so, give details of such cases.	Commonly, list of documents to be obtained from borrower for various types of credit facilities is available in bank loan manual or bank circulars. In the cases verified by auditor, if he comes across any deviation in execution of documents as per procedure, same should be commented with details of accounts and documents not obtained.
ii) In respect of advances examined by you, have you come across instances of deficiencies in documentation, non-registration of charges, non-obtaining of guarantees etc.? If so give details of such cases.	If during verification the auditor comes across any deficiencies in documentation particularly as mentioned in questionnaire, same should be reported.
iii) Whether advances against lien of deposits have been properly granted by marking lien on the deposits in accordance with the guidelines of the controlling authorities of the Bank.	If in the cases verified by him the auditor finds any deviation in process of marking lien on FDR pledged against loan, such cases should be commented with details of deviations. Key points which can be verified by auditor are given below: <ul style="list-style-type: none"> <li>• Lien of FDR receipt has been marked by branch officials.</li> <li>• FDR is properly discharged by all the parties to deposit.</li> <li>• Signature discharging the FDR has been verified by branch officials.</li> <li>• In computerised branches, lien has been marked in computer also.</li> <li>• Similarly, in case of loans against LIC/NSC/KVP, lien has been got marked in favour of bank from LIC/ Post Office as per prescribed procedure.</li> </ul>
<b>d) Review/Monitoring Supervision</b>	
i) Is the procedure laid down by the controlling authorities of the Bank for periodic review of advances including periodic balance confirmation/ acknowledgement of debts, followed by the Branch? Provide analysis of the accounts overdue for review/renewal	It should be verified as to whether branch has followed procedures laid down by bank for timely review/renewal. In case of any deviation in process, it should be commented upon. The following should also be verified: <ul style="list-style-type: none"> <li>• That at the time of review/renewal, there is system of recording adverse remarks already reported in internal audit report/concurrent audit reports in review note.</li> </ul>

<p>a) between 6 months and 1 year and b) over one year</p>	<ul style="list-style-type: none"> <li>• That there is system of obtaining the latest balance sheet, other supporting papers, key information required for review/renewal.</li> <li>• Periodic balance confirmation of debts, to ensure that documents are not time barred, has been obtained.</li> <li>• The details should be collected about accounts overdue for review/renewal from concurrent audit report, internal audit reports, review/renewal register and furnish the details of accounts due for review/renewal between 6 months and 1 year and over one year.</li> <li>• It should be verified as to whether accounts, due for review/renewal more than 180 days reported in LFAR, are NPA as per clause No 4.2.4 (ii) of Master Circular on Prudential norms RBI/2009-10/39, DBOD.No.BP.BC. 17 /21.04.048/2009-10 dated July 1, 2009. In case, account is NPA as per above guidelines, account should either be declared by branch as NPA or auditor should recommend same in MOC.</li> </ul>
<p>ii) Are the stock/book debt statements and other periodic operational data and financial statements etc., received regularly from the borrowers and duly scrutinised? Is suitable action taken on the basis of such scrutiny in appropriate cases?</p>	<ul style="list-style-type: none"> <li>• It should be verified that stock/book debt statements/ QIS data, other periodical operational data and financial details are being received regularly as prescribed. In cases where statements are not received, same should be commented upon with detailed particulars of account and period since when statements not received. For these details, apart from document files, auditor can take help of stock statement/DP register, concurrent audit report and internal audit reports.</li> <li>• It should be verified that statements received are being scrutinised by branch officials and if there is any adverse observation, suitable action has been taken by branch. If process is not being followed, auditor should comment in this regard in the report with details of accounts.</li> <li>• Verify as to whether accounts, where stock statements have not been received since long and commented in LFAR, will become NPA as per clause 4.2.4 (i) of Master circular on Prudential norms RBI/2009-10/39, DBOD.No.BP.BC. 17 /21.04.048/2009-10 dated July 1, 2009. In case, account is NPA as per above guidelines, account should either be declared by branch as NPA or auditor should recommend same in MOC.</li> </ul>
<p>iii) Whether there exists a system of obtaining reports on stock audit periodically? if so, whether the branch has complied with such system?</p>	<p>Auditor should verify, that branch is obtaining stock audit reports periodically in all the cases as required by bank policy. If stock audit reports were not obtained as per bank procedure, same should be commented in report. Further, verify deficiencies, reported in report, have since been rectified, if pending, auditor should give the details of pending issues.</p>
<p>iv) Indicate the cases of advances to non-corporate entities with limits beyond Rs. 10 lakhs where the branch has not obtained the accounts of borrowers, duly audited under RBI guidelines with regard to compulsory audit or under any other statute.</p>	<p>Auditor should obtain from branch a complete list of all the accounts where limits have been sanctioned or renewed beyond Rs. 10 lakhs. Auditor should verify that in all cases, branch has obtained the latest audited accounts of borrowers. In case of deviation, auditor should give the details of all such accounts along with sanctioned limit and outstanding balances.</p>
<p>v) Has the Inspection or Physical Verification of securities charged to the Bank been carried out by the branch as per the procedure laid down by the controlling authorities of the Bank?</p>	<p>Every bank is having system of conducting physical verification of securities periodically. Auditor should obtain a list of cases where physical verification is not done as per prescribed guidelines. Auditor should review inspection register maintained by branch to find out such accounts.</p>
<p>vi) In respect of advances examined by you, have you come across cases of deficiencies in value of securities and inspection thereof or any other adverse features such as frequent /</p>	<ul style="list-style-type: none"> <li>• In the cases examined, if auditor comes across any deficiencies in value of securities, frequent overdrawn, unauthorised overdrawn, inadequate insurance cover, he should give the detail particulars</li> </ul>

<p>unauthorised overdrawing beyond limits, inadequate insurance coverage, etc.?</p>	<p>of these accounts along with adverse features observed.</p> <ul style="list-style-type: none"> <li>In case of cash credit limits, verify that there should not be major variation between stock/ book debts/ creditors figures being submitted in monthly statement and audited accounts. If there is material variation between both the figures, particularly at balance sheet date of the borrower without any justification, same should be commented.</li> </ul>
<p>vii) In respect of leasing finance activities, has the branch complied with the guidelines issued by the controlling authorities of the Bank relating to security creation, asset inspection, insurance, etc.? Has the branch complied with the accounting norms prescribed by the controlling authorities of the Bank relating to such leasing activities?</p>	<p>Prescribed guidelines on noted issues should be verified and commented upon if there is any deviation.</p>
<p>viii) Are credit card dues recovered promptly?</p>	<p>Verify the system prevailing for recovery of credit card dues. Verify whether credit cards dues are being recovered promptly and in case, dues are not recovered, branch has done follow up for recovery.</p>
<p>ix) Has the branch identified and classified advances into standard/sub-standard/ doubtful/ loss assets in line with the norms prescribed by the Reserve Bank of India (The auditor may refer to the relevant HO instructions for identification of NPAs and classification of advances).</p>	<p>It should be verified as to whether branch has identified and classified advances as per RBI Master Circular – Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to advances bearing No RBI/2009-10/39, DBOD.No.BP.BC. 17 / 21.04.048/2009-10 dated July 1, 2009. If there is any deviation to RBI circular and HO instructions same should be commented.</p>
	<p><b>Master data in computer for NPA norms verification</b> Sometimes, master data of loans accounts are wrongly updated in computer, particularly details relating to period of loan, due date of first instalment and instalment amount. Due to these errors, statement of overdue accounts will not be generated correctly by computer. Hence due to incorrect overdue statement, there is possibility that some accounts will not be declared NPA. So, Auditor should take care of this aspect while verifying the compliance of NPA norms. Instances are given below:</p>
	<p><b>Terms loans with moratorium period (Like housing loans etc.).</b> <b>Example –</b> Loan is sanctioned with the conditions that interest debited during moratorium period will be paid only after end of moratorium period along with EMI. In such cases, interest will not be paid during moratorium period and EMI shall be fixed by adding the interest accrued during moratorium period to the principal amount. Auditor should verify, whether EMI amount is correctly calculated by computer as mentioned above. In case, EMI is calculated only for principal amount, account can become NPA due to non-servicing of interest debited during moratorium period. Auditor should take care of this aspect while verifying the compliance of NPA norms in such type of cases. <b>Example –</b> Loan is sanctioned with the conditions that interest due during moratorium period will be paid as and when due. In such cases, interest will be served during moratorium period and EMI shall be calculated only for principal amount. Sometimes, overdue statement generated by computer, does not show the unserved interest due for payment during moratorium, hence correct position of NPA cannot be assessed for such accounts on the basis of system generated overdue statement. Auditor should take care of this aspect while verifying the compliance of NPA norms.</p>
<p>x) Where the auditor disagrees with the branch classification of advances into standard/</p>	<p>If auditor does not agree with classification given by branch, he should give details along with reasons for the</p>

<p>substandard/doubtful/loss assets, the details of such advances with reasons should be given. Also indicate whether suitable changes have been incorporated/suggested in the Memorandum of Changes.</p>	<p>same. Auditor should also indicate whether suitable changes have been incorporated in Memorandum of Changes also.</p>
<p>xi) Have you come across cases where the relevant controlling authority of the Bank has authorised legal action for recovery of advances or recalling of advances but no such action was taken by the branch? If so give details of such cases.</p>	<p>Where approval for legal action for recovery of advances has been obtained from controlling authority of bank, auditor should ask for the list of cases from the management. Auditor should verify these cases and comment where branch has not taken any legal action so far or taken with delay.</p>
<p>xii) Have all non performing advances been promptly reported to the relevant Controlling Authority of the bank? Also state whether any rehabilitation programme in respect of such advances has been undertaken and if so, the status of such programme.</p>	<p>It should be examined as to whether all NPAs are being promptly reported to controlling authority of the bank or not. Verify the cases where process of rehabilitation has been initiated and give the present status of such cases.</p>
<p>xiii) Have appropriate claims for DICGC and ECGC/ Insurance and subsidies, if any, been duly lodged and settled? The status of pending claims giving year-wise breakup of numbers and amounts involved should be given in the prescribed format.</p>	<ul style="list-style-type: none"> <li>• Auditor should verify that there is process of identifying the cases, where claims are required to be lodged with DICGC and ECGC. Verify, whether in required case, branch has taken step for lodging the claims and same have been lodged.</li> <li>• Auditor should obtain the numbers of accounts with outstanding balance relating to DICGC and ECGC claims. He should furnish year-wise breakup of number of account with amount in prescribed format for claims as at beginning of the year, claims lodged, accepted /settled/ rejected during the year and balance at year end.</li> </ul>
<p>xiv) In respect of non-performing asset, has the branch obtained valuation reports from approved valuers for the fixed assets charged to the Bank once in three years, unless the circumstances warrant a shorter duration.</p>	<ul style="list-style-type: none"> <li>• Auditor should verify whether, in case of NPA accounts, branch has obtained approved valuer report for fixed assets charged to bank once in three years or shorter duration as prescribed by the bank. If there is any deviation same should be commented upon.</li> <li>• Auditor should also verify compliance of Notes given at the end of clause 5.3 of Prudential norms master circular dated July 1, 2009 for stock audit and valuation of collaterals by external agencies in case of NPAs with balance of Rs. 5 crore and above.</li> </ul>
<p>xv) In the cases examined by you has the branch complied with the recovery policy prescribed by the controlling authorities of the Bank with respect to compromise / settlement and write off cases? Details of cases of compromise/ settlement and write off cases involving write offs/waivers in excess of Rs. 50 lakhs is to be furnished.</p>	<ul style="list-style-type: none"> <li>• Auditor should verify the cases of compromise/ settlement and write off during the year. Auditor should verify that prescribed policy of the bank for compromise/settlement and write off is followed by the branch. Approval from designated authority has been obtained as per policy in all cases.</li> <li>• Auditor should obtain the details of all cases of compromise/ settlement and write off cases involving write off/waiver in excess of Rs. 50 lakhs and submit along with report.</li> </ul>
<p>xvi) List the major deficiencies in credit review, monitoring and supervision.</p>	<ul style="list-style-type: none"> <li>• In the cases verified by auditor, if he comes across any major deficiencies in credit review, monitoring and supervision, he should comment. In case, he finds any deviation of RBI guidelines same should also be commented upon.</li> </ul> <p>Some important RBI circulars are given below:</p> <ul style="list-style-type: none"> <li>• Auditor should refer to RBI circular No. RBI/2008-09/462 A. P. (DIR Series) Circular No. 66 April 28, 2009 which prohibits banks from granting fresh loans or renewing existing loans in excess of Rs. 100 lakhs (Earlier limit was Rs. 20 lakhs) against NR(E)RA and FCNR (B) deposits either to account holder or to third parties. Comment if there is any deviation.</li> <li>• Auditor can also refer to RBI Master Circular— Loans and Advances—Statutory and Other Restrictions dated July 1, 2009.</li> </ul>

<b>e) Guarantees and Letters of Credit</b>	
<p>i) Details of outstanding amounts of guarantees invoked and funded by the branch at the end of the year may be obtained from the management and reported in the following format :</p> <p>a) Guarantees Invoked, paid but not adjusted: Sl. No Date of invocation Name of the party Name of beneficiary Amount Date of recovery Remarks</p>	<ul style="list-style-type: none"> <li>• Auditor should obtain a list of guarantees invoked and funded by branch but not adjusted and kept in separate account. All the details should be furnished in prescribed format.</li> <li>• While reporting these cases in LFAR, auditor should also verify simultaneously that whether after considering above funds as part of principal operating account, the facility is becoming NPA, if yes, same should be reported in MOC also for income recognition, asset classification and provisioning.</li> <li>• For above issue, auditor can refer to clause 4.2.7 (ii) of the RBI Master circular – Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to advances bearing no RBI/2009-10/39, DBOD.No.BP.BC. 17 /21.04.048/2009-10 dated July 1, 2009.</li> </ul>
<p>b) Guarantees Invoked, paid not paid :</p> <p>Sl. No Date of invocation Name of the party Name of beneficiary Amount Date of recovery Remarks</p>	<ul style="list-style-type: none"> <li>• Auditor should obtain relevant data from branch and furnish the details in the prescribed format.</li> <li>• In case, branch informs that there is no such case, where guarantee is invoked but not paid, auditor should obtain a certificate from the branch that no guarantee is pending for payment which has been invoked up to 31-3-2010.</li> </ul>
<p>ii) Details of the outstanding amounts of letter of credit and Co-acceptances funded by the branch at the end of the year may be obtained from the management and reported in the following format:</p> <p>Sl. No. Date of funding Name of the party Nature (LC/acceptance etc.) Amount Date of recovery Remarks</p>	<ul style="list-style-type: none"> <li>• Auditor should obtain a list of LC/acceptances funded by branch and outstanding as on 31-3-2010. All the details should be furnished in prescribed format.</li> <li>• Auditor should refer to clause 4.2.7 (ii) of RBI Master circular – Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to advances dated July 1,2009 for considering the funding of LC as a part of principal operative account for income recognition, asset classification and provisioning. This issue has already been commented in detail under item – Guarantees Invoked, paid but not adjusted.</li> </ul>
<b>6 Other Assets</b>	
<p>a) <b>Stationery and Stamps</b></p> <p>i) Does the system of the Bank ensure adequate internal control over issue and custody of stationery comprising of Security Items (Term Deposit Receipts, Drafts, Pay Orders, Cheque Books, Traveller’s Cheques, Gift Cheques, etc.)? Whether the system is being followed by the branch?</p>	<ul style="list-style-type: none"> <li>• Auditor should obtain the prescribed guidelines from the bank with regard to internal control over issue and custody of security items. Auditor should select sample of few dates and comment in case, prescribed guidelines are not being followed by branch.</li> </ul> <p><b>Example – Internal Control for issue of stationery Issue of cheque Books</b> – Verify, whether prescribed processes have been followed by branch i.e. receipt of requisition slips/requests letters, approval for issuance of cheque books, signature verification on requisition slip or request letter, obtaining signature of customer at the time of handing over the cheque book.</p> <p><b>DD/PO/Term deposits</b> – Verify that DD/PO and term deposits receipts have been handed over to applicant/ account holder only after verifying the signature of recipient.</p>
	<p><b>Issuance of security items to person other than account holder</b></p> <p>If, security items were issued to third person (other than account holder), verify, whether prescribed process for obtaining authority letter with attested signature of recipient from account holder is followed, if not comment.</p> <ul style="list-style-type: none"> <li>• Auditor should verify controls with regard to security items at following points <ul style="list-style-type: none"> <li>a) Stock in joint custody (bulk stock).</li> <li>b) Stock in individual custody.</li> <li>c) Control over inventory not supported by computer</li> </ul> </li> </ul>

	<p>d) Verify branch is having system of periodical verification and reconciliation of inventory of security items. If system is not in place comment in report.</p> <p><b>Other Security Items</b></p> <ul style="list-style-type: none"> <li>ATM cards/Debit cards/PINs/Retained cards etc. are also security items. Auditor should ask for prescribed system in branches for issuance, custody and stock records of these security items like other security items as discussed earlier. If any deviation is observed in processes, same should be commented.</li> <li>Most important control generally applicable in all the banks — ATM cards and PINS should be kept in different custodies because, if one person is custodian of both the items, there is chance of misappropriation.</li> </ul>
<p>ii) Have you come across cases of missing/lost items of such stationery?</p>	<ul style="list-style-type: none"> <li>If auditor comes across any case of missing/lost security item during audit or reported in concurrent audit report, internal audit report, same should be commented in LFAR.</li> <li>Further, if no missing/lost security items found in bank records reviewed by auditor, obtain a letter from Branch Manager also that there is no missing/lost item at branch.</li> </ul>
<p><b>b) Suspense Accounts/Sundry Assets</b></p>	
<p>i) Does the system of the Bank ensure expeditious clearance of items debited to Suspense Accounts? Details of old outstanding entries may be obtained from the branch and the reasons for delay in adjusting the entries may be ascertained. Does your scrutiny of the accounts under various sub-heads reveal balances, which in your opinion are not recoverable and would require a provision/write off? If so, give details in the format.</p>	<p><b>Expeditious clearance</b> Verify the old outstanding entries pending for adjustment, auditor should obtain the reasons of delay in adjusting the entries. In case, auditor finds that procedure of clearance of items in suspense/sundry asset account is inadequate and entries are outstanding beyond prescribed time, comment accordingly. Review the steps taken for reversal of old entries.</p> <p><b>Instances of window dressing for expeditious clearance</b></p> <ul style="list-style-type: none"> <li>Travelling advance is being given to staff and taken back without executing any travelling frequently. In this case, advance will always remain with staff.</li> <li>Old debit entries in one asset account are reversed by transferring the amount to other asset account with new date. Ultimately, entry will not be reversed and it will always remain outstanding in one account or another.</li> </ul> <p>If auditor finds such cases, same should be reported.</p> <p><b>Old outstanding entries</b></p> <ul style="list-style-type: none"> <li>Auditor should obtain list of all old entries debited to suspense or any other sub-head of asset account along with reasons of delay. Details should be given in prescribed format in LFAR.</li> <li>In case, auditor feels that old entries are not recoverable and same require provision/write off, comment in report. He can recommend for MOC if required. Instances of sub-heads are given below:</li> <li><b>Entries debited in asset account to avoid declaring the operating accounts as NPA</b> — Debit entries received in inward clearing were debited in clearing difference account or other asset account as funds/limit/DP is not available in operating accounts, if same is debited in CC/SB/Current accounts, same will become NPA.</li> <li><b>Debit due to ATM entries</b>—In cases, customer of other branch (not connected with central server i.e. CBS) has withdrawn the money from ATM at branch under audit. Amount is pending for realisation from other branch.</li> <li>Old Clearing differences not recoverable and debited in asset accounts.</li> <li>Fraudulent withdrawals debited to asset account pending for recovery.</li> </ul>

	<ul style="list-style-type: none"> <li>• Payments of Pensions pending for recovery from Government.</li> <li>• Shortage of cash debited in asset accounts pending recovery.</li> <li>• Drafts paid, but entry is pending for reversal for want of advice from branch issuing drafts.</li> </ul>
ii) Does your test check indicate any unusual items in these accounts? If so, report their nature and the amount involved.	If auditor finds any unusual item same should be reported along with its nature and amount involved.
<b>II LIABILITIES</b>	
<b>1 Deposits</b>	
a) Have the controlling authorities of the bank laid down any guidelines with respect to conduct and operations of inoperative accounts? In the cases examined by you, have you come across instances where the guidelines laid down in this regard have not been followed? If yes, give details thereof.	Auditor should ask for prescribed procedure with respect to conduct and operation in inoperative accounts in the bank. Generally in banks, operation in inoperative accounts is permitted after obtaining request letter duly signed by customer for activation along with reason for delay in operation in accounts. Signature of customer on letter should be verified by branch officials and approval from appropriate authority should be taken as prescribed. Auditor should verify entries in inoperative accounts on test check basis. If prescribed guidelines are not adhered to same should be commented. RBI has issued circular no. RBI-2008-2009/138 DBOD.No.Leg.BC.34/09.07.005/2008-2009 dated August 22, 2008 regarding due diligence in transactions in inoperative accounts. Auditor can refer this circular.
b) After the balance sheet date and till the date of audit, whether there have been any unusual large movements (whether increase or decrease) in the aggregate deposits held at the year end? If so, obtain the clarifications from the management and give your comments thereon.	Compare the figures of deposits after balance sheet date on visit to branch with deposit figure as on balance sheet and find out any unusual variation in various heads of deposits accounts. Auditor should obtain clarification from the branch for unusual large movements of deposits and comment thereon.
c) Are there any overdue/matured term deposits at the end of the year? If so, amounts thereof should be indicated.	Give the figure of overdue deposits/matured deposits at the end of the year.
<b>2 Other liabilities</b>	
<b>Bills Payable, Sundry Deposits etc.</b>	
a) The number of items and the aggregate amount of old outstanding items pending for three years or more may be obtained from the branch and reported under appropriate heads. Does the scrutiny of the accounts under various sub-heads reveal old balances? If so, give details in the format:	Auditor should obtain the list of all old items pending for three years or more under the heads bills payable, sundry deposits etc. and details of number of items along with amount should be submitted in report for all sub-heads in the format provided by bank.
b) Does your test check indicate any unusual item or material withdrawals or debits in these accounts? If so, report their nature and the amounts involved.	Auditors should verify entries relating to material withdrawals or debits in these accounts. If any unusual transaction found same should be reported.
<b>Contingent Liabilities</b>	
List of major items of the contingent liabilities (other than Contingents' liabilities such as guarantees, letters of credit, acceptances, endorsements, etc.) not acknowledged by the branch?	The branch records should be verified for contingent liabilities and it should be found out if branch is having proper controls for recording all the contingent liabilities. The following details be also obtained from the branch: <ul style="list-style-type: none"> <li>• List of all the cases filed against branch by any person in consumer court or any other court.</li> <li>• List of any litigation cases pending against branch for claims made by any government department.</li> <li>• List of any demand raised by any office, pending for payment. Eg— Payment of stamp duty on lease deed. Payment of any municipal committee dues etc.</li> <li>• Branch keeps ready list of contingent liabilities at the time of audit. Auditor should verify that all the contingent liabilities cases are included in that list and same are correctly valued.</li> <li>• Obtain the representation from management that all contingent liabilities have been disclosed. In case of verification, if it appears to auditor that bank loss is clear, identified and not disputed, he should recommend for accounting of the liability for the same.</li> </ul>

<b>III PROFIT &amp; LOSS ACCOUNT</b>	
a) Whether the branch has a system to compute discrepancies in interest / discount and for timely adjustment thereof in accordance with the guidelines laid down in this regard by the controlling authorities of the Bank? Has the test checking of interest revealed excess/ short credit of material amount? If so, give details thereof.	<ul style="list-style-type: none"> <li>• Verify whether branch is having system of finding out the discrepancies in interest/discount and timely adjustment for the same are being done as per prescribed guidelines. If there is any deviation, auditor should comment.</li> <li>• Verify revenue audit report/ concurrent audit reports/ internal audit reports — Ensure all errors reported in these reports relating to incomes (short/excess) have been corrected in accounts. If, corrections are pending, same should be commented and MOC should be recommended if required.</li> </ul> <p>The following test checks can be applied to find out material discrepancies in computation of interest/discount income:</p> <ul style="list-style-type: none"> <li>• Take computer print of some loan accounts from all segments of Advances and verify that interest has been debited monthly/quarterly/half yearly as applicable without fail on all accounts by computer. Ensure, in no case, interest is skipped by system due to technical error.</li> <li>• Verify the master data with regard to rate of interest in sample cases, and ensure same is correctly updated as per documents. Further, also verify the calculation of interest to ensure that computer is calculating the interest correctly.</li> <li>• Verify the computer master data in case of discount income and ensure that charges schedule has been correctly updated in master data as per circulars.</li> <li>• Verify on test check basis, in case of cash credit limit/OD accounts, whether DP is being correctly and regularly updated in computer on monthly basis as per DP register to ensure correct calculation of penal interest.</li> <li>• Verify on test check basis, interest on loan against FDR has been modified according to change in rate of FDR in case of maturity or renewal of FDR.</li> </ul>
b) Has the branch complied with the Income recognition norms prescribed by RBI? (The Auditor may refer to instructions of the controlling authorities of the Bank regarding charging of interest on non-performing assets).	<ul style="list-style-type: none"> <li>• Refer to Master circular — Prudential norms on Income recognition issued by RBI and bank guidelines for income recognition. Auditor should also refer to instruction issued by the respective bank on charging and recognition of interest on NPA accounts.</li> <li>• If above guidelines have not been complied with by the branch, same should be commented by auditor in report. In case MOC is required same should be recommended.</li> </ul>
c) Whether the branch has a system to compute discrepancies in interest on deposits and for timely adjustment of such discrepancies in accordance with the guidelines laid down in this regard by the controlling authorities of the Bank? Has the test check of interest on deposits revealed any excess / short debit of material amount? If so, give details thereof.	<ul style="list-style-type: none"> <li>• Auditor should verify whether branch is having system of finding out the discrepancies in interest on deposits and timely adjustment for the same are being done as per prescribed guidelines. If there is any deviation, auditor should comment.</li> <li>• Verify revenue audit report/ concurrent audit reports/ internal audit reports — Ensure all errors reported in these reports relating to interest on deposits (excess/ short debit) have been corrected in accounts. If corrections are pending same should be commented and MOC should be recommended if required.</li> </ul> <p>The following test checks can be applied to find out major discrepancies in computation of interest on deposits:</p> <ul style="list-style-type: none"> <li>• Verify whether the accrued interest as on 31-3-2010 lying in the liability account is correctly provided as per bank guidelines.</li> <li>• Verify whether changes in rates of interest on deposits as per bank circular have been correctly updated in computers as and when, rate of interest on deposits were changed during the year.</li> <li>• Commonly, the interest of FDR/deposits is being calculated and credited to accounts by computer</li> </ul>

	<p>itself. Auditor should obtain from branch, the details of cases, where interest on FDR of large amount has been calculated manually and entries have been passed by releasing transfer voucher. Auditor should verify these vouchers on test check basis for material amount and ensure interest is correctly calculated and paid to customers.</p>
<p>d) Does the bank have a system of estimating and providing interest accrued on overdue / matured term deposits?</p>	<ul style="list-style-type: none"> <li>• Verify the bank accounting policy in this regard. In case, this activity is to be done at HO, comment accordingly.</li> <li>• In case, interest on overdue deposits is being accounted for at branch, verify the basis of making provision of interest on overdue/matured deposits. It should be as per bank prescribed policy.</li> <li>• RBI has issued Circular No RBI-2008-2009/138 DBOD.No.Leg.BC.34/09.07.005/2008-2009 dated August 22, 2008 regarding payment of interest on the fixed deposits which are matured and amount is unclaimed/unpaid. Auditors can refer this circular and ask for the bank guidelines in this regard.</li> </ul>
<p>e) Are there any divergent trends in major items of Income and Expenditure, which are not satisfactorily explained by the branch? If so, the same may be reported upon. For this purpose, an appropriate statement may be obtained from the branch management explaining the divergent trends in major items of Income and Expenditure.</p>	<ul style="list-style-type: none"> <li>• A comparative study should be done of all major income and expenditure accounts figures with the previous year figures.</li> <li>• Co-relate total interest paid to average deposits figures and total interest income to average loans figures.</li> <li>• If any major divergent trend in figures is observed after applying above test checks, auditor should obtain appropriate justification from branch explaining the divergent trends and same should be commented in report.</li> <li>• If branch does not provide the justification for major divergent trends or auditor is not satisfied with the justification given by the branch, same should be commented and auditors should give his justification also for divergent trend.</li> </ul>
<p><b>IV GENERAL</b></p>	
<p><b>1 Books and Records:</b></p>	
<p>a) In case any books of account are maintained manually, does general scrutiny thereof indicate whether they have been properly maintained, with balances duly inked out and authenticated by the authorised signatories?</p>	<p>The manual books maintained at branch should be scrutinized and it should be observed :</p> <ul style="list-style-type: none"> <li>• Whether manual records have been inked and authenticated.</li> <li>• Books should be written in legible manner.</li> <li>• Overwriting and cutting should have been properly authenticated.</li> </ul>
<p>b) <b>In respect of computerised branches</b></p> <ul style="list-style-type: none"> <li>• Whether hard copies of accounts are printed regularly?</li> </ul>	<ul style="list-style-type: none"> <li>• The list of daily reports like exceptional transactions, Cash Scroll, GL, Day Book, Sub-day Book, Dr. Balances, overdrawn etc. being printed at branch daily, weekly, fortnightly, monthly basis should be obtained.</li> <li>• It should be ensured that all the reports are being generated periodically and duly signed by senior officials of the branch as prescribed.</li> </ul> <p>Instances of exception reports are:</p> <ol style="list-style-type: none"> <li>Reports of transactions passed by staff beyond powers</li> <li>Passing transactions in inoperative accounts</li> <li>Overdue balances reports</li> <li>Temporary overdraft reports</li> <li>TOD allowed against cheque pending for clearing</li> <li>Report for changes in master data relating to advances</li> </ol>
<ul style="list-style-type: none"> <li>• Indicate the extent of computerisation and the areas of operation covered.</li> </ul>	<p>Give the list of areas which are being handled by branch on computer. Key areas are— Interest calculation of all advances and deposits, clearing operations, monitoring of overdue balances and temporary overdrafts, generation</p>

	of all exception reports, NPA provisions, advances and deposits, books of accounts; etc.
<ul style="list-style-type: none"> <li>Are the access and data security measures and other internal controls adequate?</li> </ul>	<p>Verify that access and data security measures and other internal controls are adequate at branch. Some such instances are:</p> <ul style="list-style-type: none"> <li>There should not be sharing of passwords/login id.</li> <li>Password/login id of staff, who had left the branch has been deleted.</li> <li>Access of important data/files restricted to certain passwords or login.</li> <li>Entries in inoperative account permitted to staff as per DFP.</li> <li>Option of time out is available on systems.</li> <li>Facility of change of password is available.</li> <li>Whether in system, delegation of financial powers is updated for staff along with login id.</li> <li>Report the adverse features reported in computer audit report if pending for compliance.</li> </ul>
<ul style="list-style-type: none"> <li>Whether regular back-ups of accounts and offsite storage are maintained as per guidelines of the controlling authorities of the bank?</li> </ul>	<p>The bank prescribed guidelines on this issue should be obtained and it should be verified whether the same are being strictly followed by branch.</p>
<ul style="list-style-type: none"> <li>Whether adequate contingency and disaster recovery plans are in place for loss/encryption of data?</li> </ul>	<ul style="list-style-type: none"> <li>The bank prescribed guidelines on this issue should be obtained and it should be verified as to whether the same are being strictly followed by branch.</li> <li>Verify that there are sufficient fire extinguishers as approved and same are not expired.</li> <li>Verify whether branch is provided with fire alarm facility.</li> </ul>
<ul style="list-style-type: none"> <li>Do you have any suggestions for the improvement in the system with regard to computerised operations of the branch?</li> </ul>	<p>Auditor should give suggestion to bank with regard to computerisation of operations at the end of audit in case. At present in banks, operations are being done through computer only. Instances of suggestions are given below:</p> <ul style="list-style-type: none"> <li>System should show, on screen PAN number of the account holder while accepting cash exceeding Rs. 49,999.</li> <li>System should not allow credit in cash (Rupees) in NRE account. Because, cash credit (In rupee) in NRE account is not permissible.</li> <li>System should generate summary of cash transactions for Rs. 10 lakhs and above being reported to higher authorities.</li> <li>System should show exception for issuance of DD/ PO in cash beyond permissible limit.</li> <li>System should show exception for payment of FDR in cash beyond permissible limit.</li> <li>In case of closure of FDR, system should show on screen that FDR is under lien.</li> </ul>
<p><b>2 Reconciliation of Control and Subsidiary Records</b> Have the figures, as at the year end, in the control and subsidiary records been reconciled? If not, the last date up to which such figures have been reconciled should be given under the respective heads, in the prescribed Proforma.</p>	<ul style="list-style-type: none"> <li>It should be verified that in case sub-GL is being maintained manually, branch has done balancing of all subsidiary GL at the year end, and total balance as per sub-GL balancing register should tally with GL balance.</li> <li>If sub-GL is computerised, auditor should verify that account-wise balancing report is available at year end (either hard or soft copy) and gross total in balancing report should tally with GL Balance.</li> <li>If there is any difference between Sub-GL total and GL total, details should be given as under: Head of account: Balance as per sub-GL: Balance as per GL; Difference if any: Date of last reconciliation:</li> </ul> <p><b>Checking of Differences Continuing Since Migration of Manual Data to Computers or Prior to Migration</b> Prior to migration of data from manual records to computer, in some cases, branches were reconciling sub-GL and GL</p>

	<p>balance with common differences which were continuing since long. Hence post migration of data, auditor should ask for migration data verification report and find out if there was any such difference which existed at the time of migration of data to computer. If, auditor finds any difference, then he should enquire from branch in which account such differences were parked and whether differences are still continuing. If these differences are still outstanding at year end same should be reported in LFAR.</p> <p>Auditor should obtain management representation in case no report with regard to migration of data is available and branch confirms data was migrated from manual records to computer without any differences.</p> <p><b>Provisioning of differences to reconcile GL and Sub-GL balance</b></p> <p>It can be further enquired as to whether total liability as per Sub-GL is more than the balance in GL. If yes, then in that case bank has to pay more balance to customer than the same available in GL. Hence auditor can also recommend the provision for extra liability to be paid by bank. Example is given below:</p> <table border="1" data-bbox="818 884 1431 1019"> <thead> <tr> <th>Head of A/c</th> <th>GL balance</th> <th>Sub-GL balance</th> <th>Difference</th> </tr> </thead> <tbody> <tr> <td>FDR</td> <td>Cr 120000</td> <td>Cr 140000</td> <td>Cr 20000</td> </tr> <tr> <td>SB</td> <td>Cr 100000</td> <td>Cr 110000</td> <td>Cr 10000</td> </tr> <tr> <td>Total</td> <td>Cr 220000</td> <td>Cr 250000</td> <td>Cr 30000</td> </tr> </tbody> </table> <p>In above example, total liability as per sub GL is Rs. 250000 while in GL it is appearing as Rs. 220000/-. In this case, if compensatory difference of Rs. 30000/- is not available in any other account, auditor can recommend the provision for liability of Rs. 30000 in GL by debiting to profit &amp; loss account.</p>	Head of A/c	GL balance	Sub-GL balance	Difference	FDR	Cr 120000	Cr 140000	Cr 20000	SB	Cr 100000	Cr 110000	Cr 10000	Total	Cr 220000	Cr 250000	Cr 30000
Head of A/c	GL balance	Sub-GL balance	Difference														
FDR	Cr 120000	Cr 140000	Cr 20000														
SB	Cr 100000	Cr 110000	Cr 10000														
Total	Cr 220000	Cr 250000	Cr 30000														
<p><b>3 Inter-Branch Accounts</b></p>																	
<p>a) Does the branch forward on a daily basis to a designated cell / Head Office, a statement of debit / credit transactions in relation to other branches?</p>	<p>Statements are sent by branches showing debit and credit transactions relating to other branches on daily basis to designated cell/Head Office. During test check, if auditor finds that reports are not submitted, details for such dates should be given in report.</p>																
<p>b) Does a check of the balance in the Head Office Account as shown in the said statement during and as at the year end reveal that the same is in agreement with the Head Office account in the General Ledger.</p>	<p>Verify the balance of Head Office account reported in daily statement with the balance of same account as per GL during and as at year end. If any difference is found on sample dates verified by auditor, he should comment the balances as per daily statement and as per GL with reason of differences.</p>																
<p>c) Are there any outstanding debits in the head office account in respect of inter-branch transactions?</p>	<p>The details of debit balance lying in Head office Account in respect of inter-branch transactions from branch should be asked for and the auditor should review these entries. Based on his review, he should reach to conclusion about reversal of entries by debiting to charges account or any provisioning is required.</p>																
<p>d) Does the branch expeditiously comply with / respond to the communications from the designated cell/Head Office as regards unmatched transactions? As at the year end are there any unresponded/ uncomplined queries or communications? If so, give details.</p>	<p>The correspondence file with designated cell / Head Office for unmatched transactions should be obtained. If there are any unresponded/ uncomplined queries or communication, same should be commented along with details of transactions.</p>																
<p>e) Have you come across items of double responses in the Head Office account? If so, give details.</p>	<p>If auditor comes across any transaction for which double responses have been received by branch, the same should be commented upon with details of transactions.</p>																
<p>f) Are there any old / large outstanding transactions / entries at debits as at year end which remains unexplained in the accounts relating to interbranch adjustments.</p>	<p>Verify and report any old/ large outstanding transactions/ entries at debits as at year end which remains unexplained.</p>																

<b>4 Audits / Inspections</b>	
a) Is the branch covered by concurrent audit or any other audit / inspection during the year?	It should be ensured as to whether branch is covered by concurrent audit or any other audit/ inspection during the audit. If not covered, the same should be commented upon accordingly.
b) In framing your audit report, have you considered the major adverse comments arising out of the latest reports of the previous auditors, concurrent auditors, stock auditors or internal auditors or in the special audit report or in the inspection report of the Reserve Bank of India? State the various adverse features persisting in the branch though brought out in these audit / inspection reports.	All the noted reports should be sought. The auditor should find out major adverse remarks in these reports and incorporate in LFAR if still pending or continuing. Whether remedial actions have been taken by branch if not comment.
<b>5 Frauds</b>	
Furnish particulars of frauds discovered during the year under audit at the Branch, together with your suggestions, if any, to minimise the possibilities of their occurrence.	The records/registers maintained at branch for frauds discovered during the year under audit should be gone through to know the nature of frauds. Obtain list of frauds duly signed by branch manager, which were discovered during the year under audit and give suggestions to minimise the possibilities of their occurrence. For frauds, Auditors can refer RBI Master circular No. DBS. FrMC. BC. No. 1/23.04.001/2009-10 dated July 1, 2009 for classification and reporting on fraud.
<b>6 Miscellaneous</b>	
a) Does the examination of the accounts indicate possible window dressing?	Verify whether large number of deposits accepted at year end and refunded immediately after the date of balance sheet. Deposits and advances from/to same borrower/ sister concern / group at year end. In case auditor is of opinion that there is possibility of window dressing same should be reported.
b) Does the branch maintain records of all the fixed assets acquired and held by it irrespective of whether the values thereof or depreciation thereon have been centralised? Where documents of titles in relation to branch or other branches are available at the branch, whether the same have been verified.	<ul style="list-style-type: none"> <li>It should be ensured that branch is maintaining fixed assets records at branch and if not, comment upon the same.</li> <li>The auditor should verify title deeds with the records maintained at branch and whether all title deeds are available at branch. If any document is missing, same should be reported.</li> </ul>
c) Are there any other matter which you, as branch auditor, would like to bring to the notice of the management or the Central Statutory Auditors?	In case auditors want to bring any major issue to the notice of the management or Central Statutory Auditors, the same can be commented upon.  <b>Example</b> <ul style="list-style-type: none"> <li>Banks are selling gold. If there is difference in gold quantity same can be commented.</li> <li>TDS on interest is not being correctly deducted in computers.</li> <li>Any other major lapse in system or any observation not covered in LFAR specifically, auditor should report in this clause.</li> </ul>
<b>Questionnaire Applicable to Specialised Branches</b>	Members can refer Guidance Notes on Audit of Banks issued by ICAI time to time for questionnaire applicable to specialised branches.

# Suggested List of Relevant RBI Circulars

Note: The following is a suggested list of the RBI circulars, which may be useful to the members undertaking statutory audit of the financial statements of banks for the period ended March 31, 2010. Readers are requested also to see the other relevant circulars being issued by RBI from time to time.

## Master Circulars

S. No.	Circular Number	Date of Issue	Subject
1.	RBI/2009-2010/71 DBOD No. Dir. BC.15/13.03.00/ 2009-10	1.7.2009	Exposure Norms
2.	RBI/2009-2010/70 DBOD. No. Dir. BC. 14 /13.03.00/2009-10	1.7.2009	Guarantees and Co-acceptances
3.	RBI/2009-2010/69 DBOD No. Dir. BC 13/13.03.00/2009-10	1.7.2009	Loans and Advances – Statutory and Other Restrictions
4.	RBI/2009-2010/66 DBOD. No. Dir. BC 10/13.03.00/2009-10	1.7.2009	Interest Rates on Advances
5.	RBI /2009-2010/65 DBOD. No. FSD. BC 18/ 24.01.001/2009-10	1.7.2009	Para-banking Activities
6.	RBI/2009-2010/64 DBOD. No. FSD. BC.19 / 24.01.011/2009-10	1.7.2009	Credit Card Operations of banks
7.	RBI/2009-2010/62 DGBA. GAD. No. H. 4 /31.12.010/2009-10	1.7.2009	Conduct of Government Business by Agency Banks - Payment of Agency Commission
8.	RBI/2009-2010/61 DGBA. GAD. No. H- 3 /31.05.001/2009-10	1.7.2009	Disbursement of Pension by Agency Banks
9.	RBI/2009-2010/60 DGBA. GAD. No. H-2 /42.01.034/2009-10	1.7.2009	Collection of Direct Taxes- OLTAS
10.	RBI/2009-2010/46 FMD. MSRG. No. 36/02.08.003/2009-10	1.7.2009	Call/Notice Money Market Operations
11.	RBI/2009-2010/44 DBOD No. DL. BC. 16 /20.16.003/2009-10	1.7.2009	Wilful Defaulters
12.	RBI/2009-2010/40 RPCD. MFFI. BC. No.09/12.01.001/2009-10	1.7.2009	Micro Credit
13.	RBI/2009-2010/42 DBOD. BP. BC No.22/21.04.018/2009-10	1.7.2009	Disclosure in Financial Statements - Notes to Accounts
14.	RBI/2009-2010/26 Master Circular No. 06/2009-10	1.7.2009	Risk Management and Inter-Bank Dealings
15.	RBI/ 2009-2010/20 DBOD No. BP. BC.3/21.04.141/2009-10	1.7.2009	Prudential norms for classification, valuation and operation of investment portfolio by banks
16.	RBI/2009-2010/37 DBOD. No. BP. BC. 6/21.01.002/2009-10	1.7.2009	Prudential Norms on Capital Adequacy Basel I Framework
17.	RBI/2009-2010/43 DBOD. No. BP. BC. 21/21.06.001/2009-10	1.7.2009	Prudential Guidelines on Capital Adequacy and Market Discipline - Implementation of the New Capital Adequacy Framework (NCAF)
18.	RBI/2009-2010/39 DBOD. No. BP. BC. 17/21.04.048/2009-10	1.7.2009	Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances
19.	RBI/2009-2010/163 DBOD No. .Ret.BC.45/12.01.001/2009-10	18.9.2009	Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)

## General Circulars

S. No.	Circular Number	Date of Issue	Subject
1.	RBI/2009-2010/272 DBOD Dir BC 66 / 13.03.00/2009-10	23.12.2009	Banks' Exposure to Capital Market – Loans extended by banks to Mutual Funds and Issue of Irrevocable Payment Commitments (IPCs)
2.	RBI/2009-2010/248 DBOD No FID FIC 6 /01.02.00/2009-10	08.12.2009	Second Quarter Review of Monetary Policy for the year 2009-10 Provisioning Coverage for Advances
3.	RBI/2009-2010/238 DBOD No BL BC 63 / 21.01.009/2009-10	30.11.2009	Financial Inclusion by Extension of Banking Services – Use of Business Correspondents (BCs)
4.	RBI/2009-2010/234 AP (Dir Series) Circular No. 16	27.11.2009	Memorandum of Instructions for Opening and Maintenance of Rupee /Foreign Currency Vostro Accounts of Non-resident Exchange Houses

S. No.	Circular Number	Date of Issue	Subject
5.	RBI/2009-2010/229 DBOD AML No 8923 /14.01.032/2009-10	20.11.2009	Know Your Customer (KYC) Norms/ Anti-Money Laundering (AML) Standards/Combating of Financing of Terrorism (CFT)
6.	RBI/2009-2010/225 DBOD No FSD BC 60 / 24.01.001/2009-10	16.11.2009	Marketing/distribution of mutual fund/insurance etc., products by banks
7.	RBI/2009-2010/215 DPSS (CO) RTGS No.949/04.04.002 / 2009 - 2010	11.11.2009	RTGS System – Mandatory Beneficiary Account Number
8.	RBI/2009-2010/214 RPCD.CO. RRB.BC No. 41/03.05.28(B)/ 2009-10	9.11.2009	Maintenance of Cash Reserve Ratio (CRR) on Exempted Categories
9.	RBI/2009-2010/213 DBOD.No.Leg. BC.59 / 09.07.005/2009-10	9.11.2009	Dishonour of Cheques – Dealing with incidents of frequent dishonour
10.	RBI/2009-2010/208 DBOD. No. Ret. BC.57/ 12.01.001/2009-10	5.11.2009	Maintenance of Cash Reserve Ratio (CRR) on Exempted Categories
11.	RBI/2009-2010/207 Ref: DBOD. Ret.BC.No.56/12.02.001/2009-10	5.11.2009	Section 24 of the Banking Regulation Act, 1949- Shortfall in Maintenance of Statutory Liquidity Ratio (SLR)- Additional Liquidity Support under Liquidity Adjustment Facility (LAF)
12.	RBI/2009-2010/202 DBOD.Leg. No.BC. 55 / 09.07.005 /2009-10	30.10.2009	Inoperative Accounts
13.	RBI/2009-2010/197 MPD.BC.326 / 07.01.279/2009-10	28.10.2009	Interest Rate Ceiling on Rupee Export Credit
14.	RBI/2009-2010/195 DBOD.Ret. BC. 51/ 12.02.001/2009-10	28.10.2009	Section 24 of the Banking Regulation Act, 1949 Maintenance of Statutory Liquidity Ratio (SLR)
15.	RBI/2009-2010/192 FMD.MOAG. No.41/ 01.01.01/2009-10	27.10.2009	Special Term Repo Facility
16.	RBI/2009-2010/184 IDMD No.1764 / 11.08.38/2009-10	16.10.2009	Settlement of OTC transactions in corporate bonds on DvP-I basis
17.	RBI/2009-2010/168 DBOD.No.BP.BC. 46/21.04.048/2009-10	24.9.2009	Prudential Norms on Income Recognition, Asset Classification, and Provisioning pertaining to Advances - Computation of NPA Levels
18.	RBI/2009-2010/167 DBS.CO.No. PP. BC. 8/11.01.005/ 2009-10	24.9.2009	Exposure to Real Estate Sector- Assessment of Group Risk
19.	RBI/2009-2010/151 DBOD.BP.BC.No. 42 /08.12.015/ 2009-10	9.9.2009	Guidelines on Classification of Exposures as Commercial Real Estate (CRE) Exposures
20.	RBI/2009-2010/147 DBOD.No.BP.BC. 38/21.01.002/2009-10	7.9.2009	Issue of Subordinated Debt for Raising Tier II Capital
21.	RBI/2009-2010/141 IDMD.PDRD.No. 1056/03.64.00/2009-10	1.9.2009	Guidelines on Exchange Traded Interest Rate Derivatives
22.	RBI/2009-2010/137 DBOD.No.BP.BC. 35/21.04.048/2009-10	31.8.2009	Agricultural Debt Waiver and Debt Relief Scheme, 2008 – Prudential Norms on Income Recognition, Asset Classification, Provisioning and Capital Adequacy
23.	RBI/2009-2010/136 IDMD.PDRD.No. 1050/ 03.64.00/2009-10	31.8.2009	Investment Portfolio of Primary Dealers Relaxation in the existing norms
24.	RBI/2009-2010/135 DBOD.BP.BC. No.34 /21.04.157/2009-10	28.8.2009	Guidelines on Exchange Traded Interest Rate Derivatives
25.	RBI/2009-2010/132 DBOD.No.BP.BC. 33/21.04.048/2009-10	27.8.2009	Prudential Treatment in respect of Floating Provisions
26.	RBI/2009-2010/129 RPCD.SME&NFS. BC.No.16/06.02.31(P) /2009-10	24.8.2009	Collateral Free loans – Micro and Small Enterprises(MSEs)
27.	RBI/2009-2010/119 DBOD.No.Leg.BC.30 /09.07.005/2009-10	12.8.2009	Payment of interest on accounts frozen by banks
28.	RBI/2009-2010/118 DBOD.No.BP.BC. 29 / 21.06.001 / 2009-10	12.8.2009	Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of the New Capital Adequacy Framework (NCAF)
29.	RBI/2009-2010/116 DBOD.No.FID.FIC.5/01.02.00/2009-10	5.8.2009	Lending under Consortium Arrangements/ Multiple Banking Arrangements
30.	RBI/2009-2010/115 DBOD No.BP.BC. 28 /21.04.141/2009-10	4.8.2009	Inter bank Participations - Scheduled Commercial Banks
31.	RBI/2009-2010/102 IDMD.DOD.No. 334/ 11.08.36/ 2009-10	20.7.2009	Ready Forward Contracts

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S. No.	Circular Number	Date of Issue	Subject
32.	RBI/2009-2010/99 DBOD.BP.BC.No. 23 /21.06.001/2009-10	7.7.2009	Introduction of Advanced Approaches of Basel II Framework in India – Time Schedule
33.	DBOD.BP.No. 502/08.12.015/2008-09	7.7.2009	Revised Draft Guidelines on Commercial Real Estate (CRE) Exposures
34.	RBI/2008-09/511 DBOD.No.BP.BC.140 /21.04.048/2008-09	25.6.2009	Agricultural Debt Waiver and Debt Relief Scheme, 2008 – Prudential Norms on Income Recognition, Asset Classification, Provisioning and Capital Adequacy
35.	RBI/2008-09/510 DBOD.No.Dir.BC. 139 /13.03.00/2008-2009	25.6.2009	Banks' Exposure to Capital Market – Loans extended by banks to Mutual Funds and Issue of Irrevocable Payment Commitments (IPCs)
36.	RBI/2008-2009/508 DBS CO.FrMC BC No 8 /23.04.001/2008-09	24.6.2009	Frauds in borrowal accounts having multiple banking arrangements
37.	RBI/2008-2009/499 DPSS (CO) RTGS No. 2246 / 04.04.002 / 2008 - 2009	16.6.2009	RTGS Transactions
38.	RBI/2008-2009/488 DBOD.No.DIR.BC.136/13.03.00/2008-09	29.5.2009	Issue of Guarantees by banks
39.	RBI/2008-2009/485 DBOD.BP.BC. No.134/21.06.001/2008-09	26.5.2009	Capital Adequacy Norms for Banks' Exposures to Central Counterparties(CCPs)
40.	RBI/2008-2009/475 DBOD.BP.BC.No.133/21.04.018/2008-09	11.5.2009	Reconciliation of nostro account and treatment of outstanding entries
41.	RBI/2008-2009/472 DBOD. No. Dir. BC. 132/13.03.00/2008-09	7.5.2009	Asian Clearing Union (ACU) - Payment of interest on ACU USD/EUR Accounts
42.	DIT Co 1/2942/09.63.36/2008-09	4.5.2009	Network based operations – RBI Supported Systems
43.	RBI/2008-2009/467 RPCD. SME&NFS. BC.No.102/06.04.01/2008-09	4.5.2009	Credit delivery to the Micro and Small Enterprises Sector
44.	RBI/2008-2009/466 DBOD.Dir.(Exp). BC.No.131/04.02.001/2008-09	29.4.2009	Rupee Export Credit Interest Rates
45.	RBI/2008-2009/463 DGBA.GAD No. H-9284 /42.01.011/2008-09	28.4.2009	Recovery of Interest from Public Sector Banks on delayed remittances of Government Receipts into Government Account
46.	RBI/2008-2009/449 Ref. DBS.CO.PPD.BC. 5 /11.01.005/2008-09	22.4.2009	Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by Banks – Compliance Certificate
47.	RBI/2008-2009/448 DBOD.No. BP. BC.127/ 21.04.009/2008-09	22.4.2009	Extension of Guarantee - Maturity beyond Ten years
48.	RBI/2008-2009/444 FMD.MOAG. No. 35/01.01.01/2008-09	21.4.2009	Special Term Repo Facility
49.	RBI/2008-09/435 DBOD.No.BP.BC.No.124/21.04.132/2008-09	17.4.2009	Prudential guidelines on restructuring of advances
50.	RBI/2008-09/434 DBOD.No.BP.BC. 125 /21.04.048/2008-09	17.4.2009	Prudential Norms on Unsecured Advances
51.	RBI/2008-09/429 DBOD.No.BP.BC. 122 /21.04.048/2008-09	9.4.2009	Prudential treatment in respect of Floating Provisions
52.	RBI/2008-09/428 DBOD No. BP. BC. 121 /21.04.132/ 2008-09	9.4.2009	Prudential Guidelines on Restructuring of Advance by Banks
53.	RBI/2008/09/426 DPSS (CO) RTGS No. 1776 / 04.04.002 / 2008 - 2009	8.4.2009	RTGS Transactions
54.	RBI/2008-09/425 DBOD.No.BP.BC. 120 /21.01.002/2008-2009	2.4.2009	Guidelines for issuing preference shares as part of regulatory capital
55.	RBI/2008-09/424 IDMD.PDRD.No.4878/ 03.64.00/2008-09	1.4.2009	Issue of Tier II and Tier III Capital
56.	RBI/2008-09/422 DBOD.No.Dir.BC. 119 /13.03.00/2008-2009	30.3.2009	Banks' Exposure to Capital Market –Loans extended by banks to Mutual Funds and Issue of Irrevocable Payment Commitments (IPCs)
57.	RBI 2008-09/418 DBOD.No.BP.BC. 118 /21.04.048/2008-09	25.3.2009	Prudential treatment of different types of Provisions in respect of loan portfolios
58.	RBI/2008-2009/387 RBI / DPSS No. 1501 / 02.14.003 / 2008-2009	18.2.2009	Credit/Debit Card transactions-Security Issues and Risk mitigation measures
59.	RBI/2008-09/376 DBOD.BP.BC.No.109/21.06.001/2008-09	5.2.2009	Introduction of Advanced Approaches of Basel II Framework in India –Draft Time Schedule
60.	RBI/ 2008-09/370 DBOD.No BP BC.105/21.04.132/2008-09	4.2.2009	Prudential guidelines on restructuring of advances by Banks



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# Valuation Audit Under Central Excise Act, 1944

**Under sections 14A and 14AA of the Central Excise Act, 1944, as amended by the Finance Act, 2009, now the Chartered Accountants are also eligible to conduct the audit either on account of valuation to be completed within specified period during any stage of enquiry, investigation or any other proceedings before any adjudicating authority, who could be appointed after getting the approval from the Chief Commissioner in jurisdiction by such adjudicating authority or on account of CENVAT credit. The article discusses how to conduct such audit.**

**U**nder sections 14A and 14AA of the Central Excise Act, 1944, as amended by the Finance Act, 2009, now the Chartered Accountants are also eligible to conduct the audit either on account of valuation to be completed within specified period during any stage of enquiry, investigation or any other proceedings before any adjudicating authority, who could be appointed after getting the approval from the Chief Commissioner in jurisdiction by such adjudicating authority or on account of CENVAT credit because of reasons to believe by the Commissioner of Central Excise in jurisdiction that the credit of duty availed or utilised is not within normal limit after considering the nature of the goods or due to fraud, collusion or any wilful misstatement or suppression of facts.

Now the issue is how to conduct such audit and for the same, the essential provisions of section 3 (2), section 4 and 4A of the Central Excise Act, 1944 read with the Central Excise Valuation Rules, 2000 shall be considered strictly and then all the relevant techniques about analysis of

transaction with the evidences and documents to ascertain the real character and consideration shall be applied accordingly.

Under the Central Excise Act, 1944, where the excise duty has been charged on *ad valorem* basis, there are three methods of valuation – one is tariff value under section 3 (2), second is valuation based on MRP and the last method is the valuation based on transaction value.

**Tariff Value**

Section 3(2) of the Act, 1944 provides that the Central Government may, by notification in the Official Gazette, fix for the purpose of levying the said duties, tariff values of any articles enumerated, either specifically or under general heading, in the [Schedule to the Central Excise Tariff Act, 1985] as chargeable with duty *ad valorem* and may alter any tariff values for the time being in force.

Section 3(3) has pointed out that the different tariff values may be fixed:

- (a) For different classes or description of the same excisable goods, or
- (b) For excisable goods of the same class or description:
  - (i) Produced or manufactured by different classes of producers or manufacturers; or
  - (ii) Sold to different classes of buyers.

The proviso to Section 3(3) points out that in fixing different tariff values in respect of excisable goods falling under sub-section (3) (b) (i) or sub-clause (ii) regard shall be had to the sale prices charged by the different classes of producers or manufacturer or, as the case may be, the normal practice of the wholesale trade in such goods.

**MRP Valuation**

Under the system of value based on MRP [i.e. the maximum retail price], the excisable goods in packaged form may be sold to the ultimate consumer and includes all taxes local all otherwise, freight transport charges, commission payable to dealers and all charges towards advertisements,

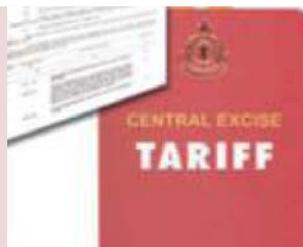
delivery, packing, forwarding and the like as the case may be, which is required to be declared on the package as per the provisions of the Standards of Weights and Measures Act, 1976 [Act No. (60) of (1976)] or the Rules made thereunder or under any other law for the time being in force as prescribed under section 4A of the Act, 1944. in cases where the Standards of Weights and Measures Act, 1976 permits for not using any MRP like sale for industrial consumption, export sale, section 4A and on the package, MRP has been reflected by the manufacturer.

Where goods are excisable goods and are packaged and further such packages are required to mention price thereof under Standards of Weights and Measures Act, 1976 or the Rules made thereunder or under any other law and further such goods are specified by Central Government by notification in the Official Gazette, then valuation of such goods would be on basis of retail sale price of such goods - Nature of sales not relevant for application of Section 4A. *Jayanti Food Processing (P) Ltd. vs. CCE* Raj. 2007 (215) E.L.T. 327 (S.C.).

Merely because the goods are specified items under sec 4A (1) of the Act, 1944, that by itself is not sufficient, the requirement is the package of such goods are required under the Standards of Weight and Measures Act and rules made thereunder or under any other similar law to declare the M.R.P. If a particular item is required to be sold in packaged form, merely because the package of such item is required to be opened for testing, contract price is not applicable merely because of the feeling that the item is not a packaged commodity at the time of the retail sale - *Whirlpool of India Ltd vs. UOI* 2007 (218) ELT-167 (SC). Merely because, small packages are packed in a carton, it could not be said that the carton is a package for retail sale to ultimate consumer - *CCE vs. Krafttech Products* 2008 (224) ELT-504 (SC).

When the duty is to be determined on such retail sale price, an abatement (as determined by

**Section 3(2) of the Central Excise Act, 1944 provides that the Central Government may, by notification in the Official Gazette, fix for the purpose of levying the said duties, tariff values of any articles enumerated, either specifically or under general heading, in the Schedule to the Central Excise Tariff Act, 1985, as chargeable with duty *ad valorem* and may alter any tariff values for the time being in force.**





**Rule 6 clearly includes value of any packing materials supplied by the buyer [free of cost or at the concessional rates] into the transaction value irrespective of the fact i.e. whether it is ordinary or special. Similarly, whatever amount is charged from the buyer for packing will be a part of the transaction value.**

the Government by way of a Notification in the Official Gazette) shall be available on account of excise duty, sale tax or other taxes because, such specific purpose of abatement irrespective of the quantum of various deductions, discounts, taxes or expenditure.

Explanation 2 to section 4A provides that –

- (a) where on the package of any excisable goods more than one retail sale price is declared, the maximum of such retail sale price shall be deemed to be the retail sale price;
- (b) where the retail sale price, declared on the package of any excisable goods at time of its clearance from the place of manufacture, is altered to increase the retail sale price, such altered retail sale price shall be deemed to be the retail sale price;
- (c) where different retail sale prices are declared on different packages for the sale of any excisable goods in packaged form in different areas, each such retail sale price shall be the retail sale price for the purposes of valuation of the excisable goods intended to be sold in the area to which the retail sale price relates.

It means where on the package of any excisable goods, more than one retail price is declared, the maximum of such retail sale price shall be deemed to be the retail sale price [Explanation 2 (a) of section 4A]. However, if on different packages, only one MRP is declared, then the assessment shall be based on such MRP declared [irrespective of the MRP declared on other packages.]

Now, each package based assessment prevails. Accordingly, on the package, if there is more than one price, and except one, all such other prices have been obliterate, it means there is only a single price on such package. What is relevant, the packaged MRP at the time of removal from the factory gate of the manufacturer should not be altered subsequently.

However, where there are more than one retail price of the same goods, but of course, because of combination package, group package, multi-piece package, etc. then each such package has its own MRP and in such a situation, the Department

should not say that the maximum of such MRP shall be the basis to charge duty in all cases because each package is a separate commodity as per the provisions under the Standards of Weights and Measures Act, 1976, read with the Standards of Weights and Measures (Packaged Commodities) Rules, 1977. In other words, different class of goods calls for separate assessment. What is a different class must be determined by keeping the commercial considerations as well as the provisions of the law.

Where different retail sale prices are declared on different packages for the sale of any excisable goods in packaged form in different areas, each such retail sale price shall be retail sale price for the purposes of valuation of the excisable goods intended to be sold in the area to which the retail sale price relates – [Explanation 2(c)].

In terms of Explanation 2 (b), where the retail sale price, declared on the package of any excisable goods at time of its clearance from the place of manufacture, is altered to increase the retail sale price, such altered retail sale price shall be deemed to be the retail sale price;

By Notification No. 5/2001 CE (N.T.) dated 1/3/2001 the Central Government has notified a series of goods on which section 4A is applicable. The abatement from the M.R.P. has been declared by the Central Government at different point of time.

When tariff value has not been fixed or the excisable goods are not assessed under section 4A, then recourse of section 4 shall be called which means the measurement shall be in terms of assessable value based on the transaction price after certain specified adjustment.

Section 4A(4) lays down that where any goods specified under sub-section (1) are excisable goods and the manufacturer –

- (a) removes such goods from the place of manufacturer, without declaring the retail sale price of such goods on the packages or declares a retail sale price which is not the retail sale price as required to be declared under the provisions of the Act, rules or other law as

## AUDITING

- referred to in sub-section (1); or
- (b) tampers with, obliterates or alters the retail sale price declared on the package of such goods after their removal from the place of the manufacture,

Then, such goods shall be liable to confiscation and the Central Government shall ascertain the prescribed manner the retail sale price for the purposes of this section.

**Explanation 1** to section 4A points out that for the purposes of this section, "retail sale price" means the maximum price at which the excisable goods in the packaged form may be sold to the ultimate consumer and includes all taxes, local or otherwise, freight, transport charges, commission payable to dealers, and all charges towards advertisement, delivery, packing, forwarding and the like and the price is the sole consideration for such sale:

**Provided that** in the case of the provision of the Act, rules or other law as referred to in sub-section (1) require declaring on the package, the retail sale price excluding any taxes, local or otherwise, the retail sale price shall be construed accordingly.

See also CBEC Circular No. 639/30/2002-CX, dated 24-5-2002-2002 (142) ELT -T33, & Circular No. 673/64/2002- CX, dated 28.10.2002-2002 (146) E.L.T. (T4), & Circular No. 625/16/2002- CX, dated 28-02-2002-2002 (140) ELT T36.

### Transaction Value – Section 4

Section 4 prevails only in the situation where section 4 A [MRP Valuation] and section 3 (2) [Tariff Value] is not applicable. For applicability of transaction value [as per section 4(1)(a)] in a given case, for assessment purposes, the following requirement must be satisfied:

- (1) The goods are sold by an assessee for delivery at the time and place of removal. The term "place of removal" has been defined basically to mean a factory or a warehouse;
- (2) The transactions are at arm's length and the assessee and the buyer of the goods are not related; and
- (3) The price is the sole consideration for sale.

If any of the above conditions is not satisfied, then transaction value shall not be the assessable

value and the value in such a case has to be arrived by applying the valuation Rules being notified in reference to section 4(1)(b) i.e. Notification No. 45/2000 C.E. (N.T.) dated 30/6/2000. i.e. the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000.

Section 4 essentially seeks to accept different transaction value for assessment based upon purely commercial consideration. However, under this concept, not only the elements which enrich the value of the goods before their marketing have been included but several considerations after sale have also been included.

The term "Transaction Value" means the price actually paid or payable for the goods, when sold, and includes in addition to the amount charged as price, any amount that the buyer is liable to pay to, or on behalf of, the assessee, by reason of, or in connection with the sale, whether payable at the time of the sale or at any other time, including, but not limited to, any amount charged for, or to make provision for, advertising or publicity, marketing and selling organisation expenses, storage, outward handling, servicing, warranty, commission or any other matter; but does not include the amount of duty of excise, sales tax or other taxes, if any, actually paid or actually payable on such goods.

The expression "payable" refers the price which is to be paid because of sale on deferred payment basis for the consignment which is subject matter of assessment rather than the price of the other consignment – *Eicher Tractors Ltd. vs. CCE 2000 (122) ELT-321 (SC)*. Excise Duty cannot be levied indirectly on a product (by including the value of a non-dutiable product like software in the value of dutiable computer, because it is impermissible to levy tax indirectly – *CCE vs. Acer India Ltd. 2004 (172) ELT-289 (SC)*).

The duty or tax means actually paid or payable on the goods under assessment, but does not mean any tax or duty paid on inputs or raw-materials of such finished goods – *Kirloskar Bors. Ltd. vs. UOI 1992 (59) ELT – 3 (SC)*. Any input credit or relief does not mean any deduction on account of duty element, but it shall be an effect of the law, so the claim of the credit or relief shall not be includible in the assessable value. In other words, input duty credit shall not be a part of the assessable value –



*Dai-Ichi Karkaria Ltd.* 1999 (112) ELT – 353 (SC). Where sale price realised includes all types of duties & taxes, by necessary implication, it would mean, it includes excise duty also, the deduction on account of duty element must be given – *CCE vs. Maruti Udyog Ltd.* 2002 (141) ELT – 3 (SC); *CCE vs. Dugar Tetenal India Ltd.* 2008 (224) ELT – 180 (SC).

In such a situation, the proper and appropriate method of determining the assessable value would be the following formula:-

**Assessable Value = Cum-duty Selling Price – permissible deduction / (1 + Rate of Duty)**

**For example,** if the Cum-duty Selling Price is known to be Rs. 3,200 and the permissible deductions are known to be Rs. 200 and the rate of excise duty is known to be 60%, the assessable value is computed as under:

**Selling Price – Permissible Deduction =**  
Rs. 3,200 – Rs. 200 = 3,000

Assessable value is equal to difference in selling price and permissible deduction divided by 1 plus 60/100 which equal to 3,000/1.6 which is equal to Rs. 1,875.

[See - *Govt. of India vs. Madras Rubber Factory Ltd.* 1975 (770 ELT 433 (SC).]

The most significant term “is liable to pay to or on behalf of the assessee” and “by reason of, or in connection with the sale” - ----- payable at the time of sale or at any other time”. “Including but not limited to”, so all the recoveries for, or in connection or because of the effect of the sale (i.e. incidental to sale shall be a part of the transaction value except the exemption/exceptions provided in the Valuation Rules or by the Central Government by issuing the circulars.- see Circular No. M.F. (D.R.) F. No. 354/81/2000 – TRU dtd. 30/6/2000 reported in 2002 (143) ELT-T39.

In a case where there is an additional consideration recovered separately, which requires redetermination of assessed value. In such a situation, the assessable value must be determined as a whole instead of charging the duty on such consideration – *Metal Box India Ltd. vs CCE* 1995 (75) ELT-449 (SC).

### Related Persons

The assumption about transaction at arm's

**Where goods are excisable goods and are packaged and further such packages are required to mention price thereof under Standards of Weights and Measures Act, 1976 or the Rules made thereunder or under any other law and further such goods are specified by Central Government by notification in the Official Gazette, then valuation of such goods would be on basis of retail sale price of such goods - Nature of sales not relevant for application of Section 4A.**



length is not applicable where the goods are sold to or through related persons. In such a situation rule 9 and 10 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 shall apply.

In terms of sec. 4 (3)(b), persons shall be deemed to be “related” if–

- (i) they are inter connected undertakings;
- (ii) they are relatives;
- (iii) amongst them the buyer is a relative and a distributor of the assessee, or a sub distributor of such distributor; or
- (iv) they are so associated that they have interest, directly or indirectly, in the business of each other.

**Explanation** – In this clause-

- (i) “inter connected undertaking” shall have the meaning assigned to it in clause (g) of section 2 of the Monopolies and Restrictive Trade Practices Act, 1969 (64 of 1969); and
- (ii) “relative” shall have the meaning assigned to it in clause (41) of section 2 of the Companies Act, 1956 (1 of 1956).

The above definition may be converted into two parts:

#### Part – I

The first part of the concept stipulates a reciprocal interest in the business of each other i.e. one may have direct interest while other may indirect interest. The quantum and degree of interest is not significant. The significance is regarding interest in business of each other i.e. the manufacturer has direct or indirect interest in the promotion in the business of the buyer as well as the buyer has an interest directly or indirectly in the promotion of business of the manufacturer – *UOI vs. Kantilal Chunilal And Ors.* 1986 (26) ELT 289 (SC); *UOI vs. Atic Industries Ltd.* 1984 (17) ELT 323 (SC), etc.

In the case of *CCE vs. T.I. Millers Ltd.* 1988 (35) ELT 8 (SC) it has laid down that interconnected

undertakings as per the provisions of the M.R.T.P. Act, are not relevant for the purpose of section 4 [because section 4 has its own concept if they are otherwise not related [see rule 10 of the Valuation Rules, 2000]]. Similarly transactions between two partnership firms may be called as the transactions between related person would ultimately depend upon the fact and circumstances of the each case – *Mohanlal Bhavsar [Deceased] Through L.R.S. and Anothers vs. UOI* 1986 (23) ELT 3 (SC).

Similarly transactions between two partnership firms may be called as the transactions between related persons would ultimately depend upon the facts and circumstances of the each case – *Mohanlal Bhavsar [Deceased] Through L.R.S. and Anothers vs. UOI* 1986 (23) ELT 3 (SC).

#### Part – II

This part points out that the holding company, subsidiary company, a relative and distributor, shall be a part of the related person.

The Supreme Court in the case of *UOI vs Bombay Tyre International Ltd.* 1983 (14) ELT 1986 (SC) has laid down that the words “a relative and a distributor of the assessee” do not refer any distributor but they are limited only to a distributor who is relative of the assessee – within the meaning of the Companies Act, 1956. However, if a distributor is not buyer but are agent of the manufacturer, then the transactions between them would be on account of related person – *Snow White Industrial Corporation vs. CCE* 1989 (41) ELT 360 (SC).

And it must be remembered that the common shareholding is not a relevant factors. If the directors are also common, it does not have any relevance if the transactions are at arm length and the price is sole consideration for the sale. Similarly transaction between the subsidiary companies of a holding company will not be on account of the related person if both the companies have no interest in the business of each other – *UOI vs. Hind Lamps Ltd.* 1989 (43) ELT 161 (SC); *UOI vs. Play World Electronics Pvt. Ltd.* – 1989 (41) ELT 368 (SC), etc.

The Apex Court in the case of *Joint Secretary vs. Food Specialities Ltd.* 1985 (22) ELT 324 (SC), AIR 1986 SC 685; *Sidhosons & ANR. vs. Union of India & Other* – 1986 (26) ELT 881 (SC); *UOI vs. Play World Electronics Pvt. Ltd.* 1989 (41) ELT 368 (SC); *UOI vs. Hind Lamp Ltd.* -1989 (43) ELT 161 (SC); *Cibatul Ltd.* – 1985 (22) ELT 302 (SC) has expressed that merely because the goods are produced with

**The expression “payable” refers the price which is to be paid because of sale on deferred payment basis for the consignment which is subject matter of assessment rather than the price of the other consignment- *Eicher Tractors Ltd. vs. CCE* 2000 (122) ELT-321 (SC). Excise Duty cannot be levied indirectly on a product (by including the value of a non-dutiable product) like software in the value of dutiable computer, because it is impermissible to levy tax indirectly.**



the brand name of the customer and the entire production are sold to him, it cannot be said that the buyer is a related person, therefore, the goods cannot be assessed on the basis of the market value obtained by the buyer who also Aids to the value of the manufactured goods as the value of their own property in the goodwill of the brand name. In other words, where the seller has manufactured goods on its own account and not on behalf of the buyer, then merely because of using the trade mark of the buyer, it could not be said that the goods were manufactured on account of the buyer if the transactions are at arm length and the price charged is sole consideration of sale.

However the shareholder of a limited company does not, by reason only of their share holding, have an interest in the business of the company. Equally, the fact that two public limited companies have common directors does not mean that the one company has an interest in the business of the other – *Alembic Glass Industries Ltd. vs. CCE&C* 2002 (143) ELT-244 (SC). However, in case of private limited companies, where both the companies are family concerns and are beneficiaries of their ventures and that the benefit of both the concerns are share by member of one and the same family. The conclusion about mutuality of interest is inevitable – *CCE vs I.T.E.C. (P) Ltd.* 2002 (145) ELT-280 (SC).

And in case of co-operative societies and federation of such societies, though societies being member of the federation may have interest in the federation but does not have vice versa- *UOI vs. Kaira Distt. Co-op. Milk Producers Union Ltd.* 2002

(146) ELT 502 (SC), the stipulation of related person is not applicable.

*Now, the treatment of few recoveries or costs is as follows:-*

**(a) Specific inclusion:** In the transaction value by section 4(3) like publicity, marketing, selling, advertising, warranty (irrespective of optional or mandatory) expenditure etc. if recovered separately from the buyer directly or indirectly, shall be included. However, where the brand name/copyright owner gets his goods manufactured from outside (on job-work or otherwise), the expenditure incurred by the brand name/copyright owner on advertisement and publicity charges, in respect of the said goods, will not be added to the assessable value, as such expenditure is not incurred on behalf of the manufacturer- assessee [See CBEC Circular No. 619/10/2002 CX dtd. 19-2-2002].

**(b) Interest on delayed payment:** In case of recovery of interest on delayed payment after allowing the normal period of credit sales without interest shall not be included in the transaction value if-

1. the interest charges are clearly distinguished from the price actually paid or payable for the goods;
2. the financing arrangement is made in writing; and
3. where required, the assessee demonstrates that such goods are actually sold at the price declared as the price actually paid or payable.

Where there is a security deposit given by the buyer to the manufacturer-assessee the notional interest is not includible if it is proved that it is not in connection with or by reason of sale and the price of the goods has not been reduced because of such security deposit. Thus, interest i.e. cost of finance for delayed payment, when not exorbitant, is to be granted abatement whether availed or not under new

section 4 also- *CCE vs. Arvind Mills Ltd.* 2006 (204) ELT -570 (T-LB).

Explanation 2 to rule 6 lays down that where an assessee receives any advance payment from the buyer against delivery of any excisable goods, no notional interest on such advance shall be added to the value unless the Central Excise Officer has evidence to the effect that the advance received has influenced the fixations of the price of the goods by way of charging a lesser price from or by offering a special discount to the buyer who has made the advance deposit.

**Illustration 1** – X, an assessee sells his goods to Y against full advance payment at Rs. 100 per piece. However, X also sells such goods to Z without any advance payment at the same price of 100 per piece. No notional interest on the advance received by X is includible in the transaction value.

**Illustration 2** – A, an assessee, manufactures and supplies certain goods as per design and specification furnished by B at a price of Rs. 10 lakhs. A takes 50% of the price as advance against these goods and there is no sale of such goods to any other buyer. There is no evidence available with the Central Excise Officer that the notional interest on such advance has resulted in lowering of the prices. Thus, no notional interest on the advance received shall be added to the transactions value."

Thus, notional interest on advance deposit will not be included in the case of goods made to specification of the buyer unless there is specific evidence that such deposit has the effect of lowering the price.

**(c) Trade Discount:** Section 4 or the Rules are silent about the same. However, the Circular stipulates that if any transaction, a discount is allowed on declared price of any goods and actually passes on to the buyers of

goods as per the common practice, the question of including the same in the transaction value does not arise. The differential discounts extended as per commercial consideration on different transactions to unrelated

**The assumption about transaction at arm's length is not applicable where the goods are sold to or through related persons. In such a situation rules 9 and 10 of the Central Excise Valuation (Determination of Price of Excisable goods) Rules, 2000 shall apply. In terms of section 4 (3)(b), Persons shall be deemed to be "related" if they are inter connected undertakings; they are relatives; or amongst them the buyer is a relative and a distributor of the assessee, or a sub-distributor of such distributor.**



**In the case of *CCE vs. T.I. Millers Ltd.* 1988 (35) ELT 8 (SC) it has laid down that interconnected undertakings as per the provisions of the MRTP Act, are not relevant for the purpose of section 4 [because section 4 has its own concept if they are otherwise not related [see rule 10 of the Valuation Rules 2000]. Similarly transactions between two partnership firms may be called as the transactions between related persons would ultimately depend upon the fact and circumstances**



buyers if extended cannot be objected to and different actual prices paid or payable for various transactions are to be accepted for working out the assessable value. It is also not the required condition to quantify the same at the time of preparation of invoice – *CCE vs. DCM Textiles* 2006 (195) ELT -129 (SC).

Where the assessee claims that discount of any description for a transaction is not readily known but would be known only subsequently, the assessment for such transaction may be made. However, the assessee has to disclose the intention of allowing such discount to the Department and make a request for provisional assessment. In case, after issuing an invoice, any subsequent reduction of sale price would have no affect unless:–

- (i) price was provisional; and
- (ii) there was a provisional assessment in terms of Rules 7. The effect of Rule 5 must also be kept in mind in which there is no provision of reassessment of assessed goods.

**(d) Packing Charges:** Rule 6 clearly includes value of any packing materials supplied by the buyer [free of cost or at the concessional rates] into the transaction value irrespective of the fact i.e. whether it is ordinary or special. Similarly, whatever amount is charged from the buyer for packing will be a part of the transaction value.

There is no exclusion on account of cost of durable & returnable packing. Notification no. 313/77 CE grants an exemption for conclusion of cost of durable packing supplied by buyer for glucose, petroleum products, acids, resins and

some other notified products. And if on account of return of packing if a supplier wants a deduction of the amount returned to the buyer, he must follow the procedure to assume it as a trade discount. However, packing material cost is not liable for inclusion if it is not sold – *Tata Chemicals Ltd.* 2006 (204) ELT-359 (SC).

**(e) Transportation Cost:** Rule 5 stipulates that where any excisable goods are sold in the circumstances specified in clause (a) of sub-section (1) of section 4 of the Act except the circumstance in which the excisable goods are sold for delivery at a place other than the place of removal, then the value of such excisable goods shall be deemed to be the transaction value, excluding the cost of transportation from the place of delivery of such excisable goods.

**Explanation 1** – “cost of transportation” includes-

- (1) the actual cost of transportation; and
- (2) in case where freight is averaged, the cost of transportation calculated in accordance with generally accepted principles of costing.

**Explanation 2** – For removal of doubts, it is clarified that the cost of transportation from the factory to the place of removal where the factory is not the place of removal, shall not be excluded for the purpose of determining the value of the excisable goods.

Thus, averaged freight, determined in accordance with generally accepted principles of costing, would be admissible for deduction in respect of transportation beyond the place of removal, where price at the place of removal is not known.

Delivery to the carrier at factory gate depot is delivery to the buyers and element of freight and transit insurance are not includible in the assessable value – At that point, ownership of goods has no relevance – *Escorts JCB Ltd. vs. CCE* 2002 (146) ELT- 31 (SC); *Prabhat Zarda Factory Ltd. vs. CCE* 2002 (146) ELT -497 (SC).

Any profit element on transportation is not includible in the assessable value – *CCE vs. GR Cables Ltd.* 2007 (208) ELT A 40 (SC) read with *Baroda Electric Meters Ltd. vs. CCE* 1997 (94) ELT - 13 (SC).

Compensation to customers for breakage or losses in transit cannot be treated as an

insurance or cost of transportation – *CCE vs. Surya Roshni Ltd.* 2002 (122) ELT-3 (SC).

- (f) **Depot Transfer:** Such transfer is now based on “normal transaction value” i.e. the transaction value at which the greatest aggregate quantity of goods from the depots, etc. are sold at or about the time of removal of the goods being from the factory or warehouse. If, however, the identical goods are not sold by the assessee from depots or consignment agents place on the date of removal from the factory or warehouse, the nearest date on which such goods were sold, shall be taken into account – see Rule 7.

The terms transaction value of the “greatest aggregate quantity” would refer to the price at which the largest quantity of identical goods are sold on a particular day irrespective of the number of buyer.

And additional recoveries from depot by providing some extra service shall not provide any effect because of Rule 5 of the CE Rules, 2002 read with section 4(3)(c) in which a depot is not a place of removal. Moreover, the CBEC Circular F. No. 139/08/2000 – CX 4 dt 3-1-2001 stipulates that such additional service should not amount to manufacture.

- (g) **Cost of materials, service, etc. freely supplied** by the buyer or at the concessional rates, such additional consideration to that extent shall be includible – see Rule 6.

Few examples of such suppliers/service provided without charging anything or at the concessional rates are:–

- Value of materials, components, parts and similar items relatable to such goods;
- Value of tools, dies, moulds, drawings, blue prints, technical maps and charts and similar items used in the production of such goods;
- Value of material consumed, including packing materials, in the production of such goods;
- Value of engineering, development, art work, design work and plans and sketches

undertaken elsewhere than in the factory of production and necessary for the production of such goods.

where the transaction is on principal to principal basis, advertisement expenses borne by the bulk buyer (buying 98% of the production) is not includible in assessable value – *Alembic Glass Industries vs. CCE 2006* (201) ELT-161 (SC).

Now any additional consideration i.e. the difference in price between the price at which goods actually sold and the offer price [*CCE vs. IFGI Refractories Ltd.* 2005 (186) ELT – 529 (SC)] equivalent to money value in terms of goods and services provided free or at reduced cost by or on behalf of the buyer to the supplier – manufacturer – assessee shall be included in the assessable value.

- (h) **Interconnected Undertakings [see Rule 10]:**

The interconnected undertakings are covered under the definition related persons. Remaining part is same as defined under section 4(4)(C) in existence prior to 1-7-2000. So far that aspect, old decisions are also relevant to the extent of adjustment about interconnected undertakings as defined in the MRTTP Act. However, even if the assessee and the buyer are interconnected undertakings, the transaction value shall be rejected only when they are “related” in the sense of any clauses (ii), (iii) or (iv) of section 4(3)(b) or the buyer is a holding company or a subsidiary company. In other words, while dealing with transactions between interconnected undertaking, if the relationship as describe in clauses (ii), (iii) or (iv) does not exist and the buyer is also not a holding company or a subsidiary company, then for assessment purposes, they will not be considered as related persons. In other words, the new definition would not be much different from that covered under the old Section 4 definition.

- (i) **Dealings with re-lated-persons:–** [see rule 9]

(1) Now the dealings with related persons are equalised with the dealings at the depots or

**In case of recovery of interest on delayed payment after allowing the normal period of credit sales without interest shall not be included in the transaction value if the interest charges are clearly distinguished from the price actually paid or payable for the goods or financing arrangement is made in writing, and where required, the assessee demonstrates that such goods are actually sold at the price declared as the price actually paid or payable.**



## AUDITING

consignment agent. The rule says that the value of goods shall be the normal transaction at which these are sold by the related persons at the time of removal (to buyers not being related persons).

- (2) In case where goods are not sold to such buyers, the transaction value shall be the value at which these goods are sold by the related person at the time of removal to the buyers (being related persons), who sells such goods in retail.
- (3) In case, where related person does not sell the goods but uses or consumes such goods in the production or manufacture of other articles, the value shall be determined in the manner specified in Rule 8 i.e. 11% of cost of production.

Rule 9 prevails only in such a such a situation when goods are sold exclusively to the related persons. If the independent price is available, the same to be applied – 2007 (209) ELT-185 (T-LB); *CCE vs. Aquamall Water Solutions Ltd.* 2006 (193) ELT –A 197 (SC). If the transaction price is not influenced by the relationship, the transaction value to be accepted – *CCE vs. Bharti Telecom Ltd.* 2008 (226) ELT-3 (SC).

- (j) **Cost of production – Rule 8:** Where transaction value is not known, but there is removal for assessment under section 4, as a measure of simplification, it has been stipulated that the assessable value shall be taken at 115% of the cost of manufacture of goods even if identical goods on comparable prices are available in the hands of the manufacturer. Cost of production means the cost based on general principles of costing as given by Cost Accounting Standard CAS 2, 3 and 4.
- (k) **Job Work:** Rule 10 A of the Valuation Rules 2000 inserted by Notification No. 9 / 2007 C.E.(N.T) dt. 1/3/2007 stipulates that where the excisable goods are produced or manufactured by a job worker on behalf of a person (hereinafter referred to as principal manufacturer), then, –
  - (i) in a case where the goods are sold by the principal manufacturer for delivery at the time of removal of goods from the factory

**The interconnected undertakings are covered under the definition related persons. Remaining part is same as defined section 4 (4) (C) in existence prior to 1-7-2000. So far that aspect, old decisions are also relevant to the extent of adjustment about interconnected undertakings as defined in the MRTP Act. However, even if the assessee and the buyer are interconnected undertakings, the transaction value shall be rejected only when they are “related” in the sense of any clauses (ii), (iii) or (iv) of section 4(3) (b) or the buyer is a holding company or a subsidiary company.**

of job-worker, where the principal manufacturer and the buyer of the goods are not related and the price is the sole consideration for the sale, the value of the excisable goods shall be the transaction value of the said goods sold by the principal manufacturer;

- (ii) in a case where the goods are not sold by the principal manufacturer at the time of removal of goods from the factory of the job-worker, but are transferred to some other place from where the said goods are to be sold after their clearance from the factory of job-worker and where the principal manufacturer and buyer of the goods are not related and the price is the sole consideration for the sale, the value of the excisable goods shall be the normal transaction value of such goods sold from such other place at or about the same time and, where such goods are not sold at or about the same time, at the time nearest to the time of removal of said goods from the factory of job-worker;
- (iii) in a case not covered under clause (i) or (ii), the provisions of foregoing rules, wherever applicable, shall *mutatis mutandis* apply for determination of the value of the excisable goods:

**Provided** that the cost of transportation, if any, from the premises, wherefrom the goods are sold, to the place of delivery shall not be included in the value of excisable goods.

**Explanation –** For the purposes of this rule, job-worker means a person engaged in the manufacture or production of goods on behalf of a principal manufacturer, from any inputs or goods supplied by the said principal manufacturer or by any other person authorised by him.

- (l) **Sales Tax Set Off:** Any set of scheme of sales tax does not change the rate of Sales tax Payable/

Chargeable on the finished goods, the set off is not to be taken into account for calculating the amount of sales tax permissible as abatement for arriving at the assessable value. It means only that amount of sales tax will be permissible as deduction under section 4 as is equal to the amount legally permissible under the local sales tax law to be charged/billed from the customer/buyer – see CBEC Circular No. 671/62/2002-CX dated 9-10-2002 reported in 2002 (1450 ELT- T 85]. However, where the set off is to be adjusted on consignment wise, the net sales tax (i.e. the amount permissible to be billed) will only be eligible for abatement – See Circular No. 643/34/2002 CX dated 1-7-2002, reported in 2002 (143) ELT – T 39.

In case, where the price is not the sole consideration for sale, but other requirements of section 4(1)(a) are satisfied, then value shall be determined as per the provisions of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000. This provided for adding to the transaction value, the money value of any additional consideration flowing directly or indirectly from the buyer to the assessee. – see rule 6

The practical implication of the new valuation system could be seen from a composite contract made by the Railway or any other buyer in which total contract consideration has been provided for all the supplies and service provided after sale. In such service some materials are to be supplied by the buyer. Now what would be the value for the supplies of such goods manufactured which is subject to various operations at the place of buyer, by consideration the expressions employed in section 4 (3) (d) e.g. “by reason of, or in connection with sale payable at the time of sale or at any other time” ----- “by including but not limited to-----”. Really we are in trouble because of giving such so-called organic structure of the statute. However, a relief is in the Circular No. CBEC F. No. 136/08/2000-CX-4 dated 3-1-2001 which is based on the decision of the Supreme Court in the case of *M/s Siddharth Tubes Ltd.* 2000 (115) ELT 32 (SC); and *J.C. Glass Ltd.* 1998 (97) ELT 5 (SC). In the circular, the Revenue i.e. the law Ministry has advised that the judgement of the *Siddharth Tubes Ltd.* 2000

(115) ELT 32 (SC) does not enable the Department to charge duty on value addition outside the factory of clearance on account of certain processes not amounting to manufacture of manufactured goods in a separate/ other unit of the same group or by any independent Job-worker [See 2001 (128) ELT-T44 -45]. And it is needless to point out that the Revenue can not challenge the effect of such circular – *Dhiren Chemical Industries Ltd.* 2001 (47) RLT 881 (SC).

In other words, if the expenditure on erection, installation and commissioning has been incurred to bring into existence any excisable commodity, these charges would be included in the assessable value of the goods. If these cost are incurred to bring into existence of an immovable property, they will not be included in the assessable value of such resultant property - Circular No. 58/1/2002/CX dated 15-1-2002 also Circular No. 643/34/2002 CX dated 1-7-2002.

**(m) “place of removal” means -**

- (i) a factory any other place or premises of production or manufacture of the excisable goods;
  - (ii) a warehouse or any other place or premises wherein the excisable goods have been permitted to be deposited without [payment of duty;]
  - (iii) a depot, premises of a consignment agent or any other place or premises from where the excisable goods are to be sold after their clearance from the factory;
- from where such goods are removed.

**(n) Residuary Rule** – Rule 11 of the Valuation Rules because of residuary one is not applicable independently without considering other rules – *Cadila Pharmaceuticals Ltd. vs. CCE 2008 (232) ELT – 245 (T-LB).*

And at the end, because of machinery provision in organic manner, it requires high degree of interpretative approach as well as full disclosure requirement in audit report, because of the appointment made by Central Excise Authority, our attempt should be oriented to disclose all such interpretation adopted by the assessee while valuing the goods, so that the excise authority could decide whether there is a case of undervaluation or not rather than by us.

# Accounting Professionals: Issues in Professional Indemnity Insurance

**Of late, risk exposure of professional accountants has increased manifold. Legal proceedings for negligent services are exposed to them in a big way now. Professional indemnity (PI) insurance provides essential financial protection for a wide range of professional advisors. It covers the firm and not the interests of their clients or third parties. This insurance is written on a claims-made basis, i.e. cover relates to claims or potential claims against the firm notified during the period of insurance, irrespective of when the alleged negligent act or omission occurred. The policy will cover the cost of legal defence in the event of a claim being made. The policy will only pay when the liability of the claimant has been established.**



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## Fundamental Principles

Professional indemnity insurance provides essential financial protection for a wide range of professional advisors. In the event that a client suffers financial loss as a result of alleged neglect, error or oversight, professional indemnity insurance will meet the cost of defending claims and any damage payable. Any Chartered Accountant, who gives advice, designs or offers a similar service in a professional capability, is seen by clients as an expert. In these times of high-end user attentiveness, clients will not postpone in pursuing a claim if they feel that they have received a substandard service. Professionals are nowadays exposed to more complications and claims and therefore a need for such an insurance has never been greater. Some professionals may see it as an expensive and avoidable overhead. Court awards have risen sharply. Without insurance, financial security of a professional is threatened.

**During the 80s, accounting profession had a loss of face as their clients turned to court frequently for compensation against loss due to professional services which led to monetary loss or a loss of goodwill. This has consequently increased the cases of insurance protection for professions seeking the cover.**



The accounting professionals have been able to organise their work and get social and statutory appreciation for their competence, objectivity and integrity. They provide high-caliber services to our society, in general, and to business community, in particular. Accounting professionals who act in a professional capacity are bound to exercise the care and skills required by competent practitioners in a profession. If they fail, they are open to action being brought against them by their client. The role of accounting professional that started with compulsory statutory audit under the Company Law, has got boost in the last 50 years towards the management consultancy, data-based management information system, costing and variance analysis and return on investment. The new dimensions added to it with the introduction of high technology, financial planning operations and management, and planning installation and operation of various types of computer, devices in office automation, production and distribution services. The information services of professionally-qualified accountants in the areas of statutory and special audit and certification of various applications, statements and opinions have strong legal backing and credibility.

Accounting profession is being organised through statutory institutional set up by an act of the Parliament that ensures not only provision of fair, equitable and competent service but also a disciplinary framework for the members of the profession. The question of liability for negligence and incompetence is normally settled through a self-regulatory mechanism and disciplinary framework of the Institute of Chartered Accountants of India (ICAI) itself. However, their services may involve prolonged litigation and quite often contradictory interpretations by our law. There are liability for negligence, incompetent handling of task assignment, etc.

Penalties may be imposed on professionals which will ruin professional practice, reputation and goodwill of the members of the accounting profession.

### Background and Evolution of Insurance

In early 50s, well-organised insurance companies in the west started 'professional liability insurance' in the nature of a cover against claims which clients preferred on professionals who provided them service. During the 80s, accounting profession had a loss of face as their clients turned to court frequently for compensation against loss due to professional services which led to monetary loss or a loss of goodwill. This has consequently increased the cases of insurance protection for professions seeking the cover. Thus against claims by clients, accountants sought to limit their liability in the conduct of audit as the risk for suits of damages became very acute. Insurance covers were so high that unlimited liability was no longer tenable.

Although, limited liability concept for business ventures was shaped and improved by corporate laws from time to time during the last 150 years, but it kept professionals like accountants outside its purview. Accountants couldn't provide their services by organising themselves into private or public limited companies.

### Shield Through PI Policy

With an increased role and responsibility of accountants in this age of globalisation, their profession has been exposed to many pitfalls and risks. Here, professional indemnity insurance covers various activities and responsibilities designed and offered. It indemnifies errors and/or omissions by the employees named in the policy or professionals that may include chartered accountants, financial accountants, management consultants, advocates, solicitors or counsels, insurance brokers, or, agents, while rendering services.



**Professional indemnity insurance provides cover for claims brought against policyholders due to their professional negligence. Liabilities may arise in the discharge of professional duties due to negligence. This indemnifies policyholders against loss/circumstances incurred only as a result of their negligent act, error or omission in carrying out the policyholders' business.**



“Every person who enters into a learned profession undertakes to exercise a reasonable degree of care and skill.” If he/she is an attorney, he/she does not undertake that in all events she/he shall win your case; nor does a surgeon undertake that she/he will perform a cure. There may be people who have higher education and greater advantages than she/he has. But she/he undertakes to bring a fair, reasonable and competent degree of skill. It follows that there are two counts upon which an action may be based for damages due to negligence: the defendant doesn't have the necessary degree of skill, and the defendant did not exercise his skills required in a particular case.

The risk to professionals for negligence is very real and the consequences of such an action can be serious: not only she/he may obtain unwanted publicity, but if the action succeeds, she/he may be made bankrupt; not only a claim may be made due to her/his personal acts, but it also may be made, arising out of the actions of any of her/his staff.

From the perspective of insurance companies, whole expense for this class of business has been unfavorable, as insurance market is very limited. On part of insurance provider, a considerable amount of skill is necessary in underwriting this business; consideration has to be given to the current reputation of the individual or firm proposing the insurance. If the firm has been established for sometime then the past experience requires investigation, and if there have been claims made against them in the past, the type of claim is very relevant, viz. claims due to:

- 1) Gross negligence of person concerned or her/his staff.
- 2) Complete lack of control on part of the partners in the profession.
- 3) Error of judgments or only its isolated, unlucky incident.
- 4) Quality of staff whether trained or untrained.

There is no standard form of policy to fit all professions. The insurance companies are having accountant's Indemnity Insurance Policy that covers incidents happening during the period of

insurance or during a specified period after the expiry of the policy. The normal exceptions are:

- 1) Claims for libel or slander.
- 2) Claims brought about or contributed to by the dishonest, fraudulent, criminal, or, malicious act or omission of the insured or his employees.
- 3) Claims for which indemnity is obtained under any other policy.

### How does the Policy Work?

This policy indemnifying against amounts one is legally liable to pay as damages to the clients, is basically governed by all fundamental principles of insurance contracts such as:

- 1) Insurable Interest: insured has insurable interest in the financial loss that arises when he has to pay damages under the law.
- 2) Indemnity: the policy will indemnify the insured to the extent of damages and costs awarded, and legal costs incurred, subject to limits of liability.
- 3) Subrogation: rights are transferable to insurer.
- 4) Contribution: all insurers pay rate able share of loss.
- 5) Utmost Good Faith: insured to disclose all material facts.

### How Civil Liability by Virtue of Law of Contract may Arise?

Professional indemnity insurance provides cover for claims brought against policyholders due to their professional negligence. Liabilities may arise in the discharge of professional duties due to negligence. This indemnifies policyholders against loss/circumstances incurred only as a result of their negligent act, error or omission in carrying out the policyholders' business. This is the narrowest form of cover.

#### *Negligent act, error or omission*

Negligence is also the reason for the liability loss exposures. In simple words, negligence means “absence of care”. Negligence can be established when the following conditions are satisfied:

- 1) Existence of duty of care towards the party
- 2) Breach of that duty

- 3) Injury or damage as a consequence of the breach
- 4) Casual connection between the breach of duty and injury or damage

#### *Civil liability*

Some professional indemnity policies go further than the standard cover and provide indemnity for any civil liability. These policies cover areas such as breach of contract, libel and slander. Some standard cover policies may also include libel and slander as extensions to the policy wordings if required.

#### *LLP and Indemnity*

Now LLP is a real body corporate which is formed by being incorporated under the related legislation and has its own separate and distinct legal existence, separate from that of its partners. It is the LLP which enters into legal agreements, not the individual partners and generally has the following features:

- 1) The law relating to General Partnership (i.e. Indian Partnership Act, 1932) is not applicable providing protection from unlimited liability.
- 2) LLP permits individual partners to be shielded from joint liability created by other partner's decision or misconduct. Thus, every partner of an LLP is the agent of the LLP but not of other partners.
- 3) An LLP has a perpetual succession.
- 4) Any change in the partners of a limited liability partnership shall not affect the existence, rights or liabilities of the LLP.
- 5) An obligation of the limited liability partnership whether arising in contract, or, otherwise is solely the obligation of the LLP. However, the personal unlimited liability of a partner for his own wrongful act or omission remains which are not done for and on behalf of LLP.

#### **How Much Cover is Required?**



**Only the professionals by their own judgment can assess the amount of cover appropriate to the profession. In determining how much cover to effect, it is important that a realistic view is taken of the potential damages and legal costs for which the professional could become liable. Being under-insured can be almost as financially disastrous as being without**

Only the professionals by their own judgment can assess the amount of cover appropriate to the profession. In determining how much cover to effect, it is important that a realistic view is taken of the potential damages and legal costs for which the professional could become liable. Being under-insured can be almost as financially disastrous as being without insurance at all. The professionals cannot afford to enter into time consuming litigations and exposed to uncertainties regarding claims and damages for various types of slips and losses to clients. The legal system should be reformed for this purpose to ensure a uniform, inexpensive and quick approach. Punitive damages should be an exception rather than the rule.

### Membership of Other Accounting Bodies Abroad

The ICAI recognises the need for CAs to be world-class advisors in an ever mounting and varying business environment. In this age of globalisation, accountants are raring to stretch their wings in the vast awning of worldwide market. The ICAI had signed mutual agreements with United Kingdom and Australia. In our country Torts Litigation are yet to take its pace but in the countries like England and Australia, it is a day-to-day legal activity.

The Companies Act, 2001 of the Mauritius provides that the members of select professional bodies, of which the ICAI is one of the indicated institutes, individually or in partnership can be appointed as a statutory auditor of a company other than a small private company. Like India, at present, there is no legal requirement to have indemnity insurance in Mauritius. However, practicing auditors are required by their individual professional bodies abroad to have professional indemnity insurance.

### Role of the Regulator and Own Safeguard Mechanism

Professional accountants are under continuous thrashing. Through various types of claims and their escalating amounts, the protection which they

can arrange through professional indemnity insurance has not only become costly, but also is not able to take care of various types of agencies to which their professional practice is exposed in a fast changing and increasingly refined accounting environments. With all the proficiency at their command, they are unable to cope up with increasing accounting frauds like those of lending money transmission, security and commodity transactions, venture capital, trade, and manufacturing. Even public investigators and policy personnel are finding it difficult to operate successfully through the corporate trade jungle which is becoming very sophisticated in view of the introduction of the computer-based management information and operating systems.

In view of the fast-growing concern and the near inability of the insurers and the governmental organisations to provide major relief against professional indemnity, the accounting profession has to organise its own safeguard mechanism that could be on the following lines:

- 1) Professionals risk programme and modules to prepare to safeguard the interests of the members.
- 2) Despite LLP's reality, the Company Law and related legislative framework to be effected to provide for the maximum damages linked to the amount of fees charged from the clients whom this service is provided.
- 3) Representation to the Government to fix the maximum liability.
- 4) Accountants to form their own insurance fund by setting aside a percentage of their fee income for meeting claims of frauds and damages caused by employees' negligence.
- 5) Continuous evaluation and rating of clients by independent agencies to ward off frivolous claims and damages.
- 6) The work relating to various types of services to be allocated taking into account the cost of indemnity insurance, the hazards of litigation and the fidelity rating of the employee and the client.



#### »» Companies Bill Likely to be Approved in Monsoon Session: MCA

The new Companies Bill, which seeks to replace the legislation enacted way back in 1952, is likely to be approved by Parliament in the monsoon session, the Secretary, Ministry of Corporate Affairs (MCA) Mr. R. Bandyopadhyay has said. The government had reintroduced the draft Companies Bill last August. With this legislation, the MCA seeks to change corporate governance norms and update the laws in accordance with the best global practices, and to strengthen the norms for dealing with corporate frauds using stricter regulations. The new legislation will protect the rights of minority shareholders and bring about responsible self-regulation with adequate disclosure and accountability.

**Source:** <http://economictimes.indiatimes.com/news/>

#### »» No Objection to Teaser Rates: RBI

Country's largest lender the State Bank of India (SBI) and other public sector banks like the Bank of India and Punjab National Bank have now decided to discontinue the 'teaser rates' on special home and auto loans despite the fact that the RBI has no objection to such rates. Banks, led by the SBI, under special schemes have been offering loans at lower interest rates for the first few years of the credit period. Though earlier, the RBI Deputy Governor Usha Thorat had said, "teaser rate by banks is a cause of concern. Banks must ensure that borrowers can service higher rates when rates return to normal."

**Source:** <http://www.hindustantimes.com/business-news/>

#### »» RBI Rules out Further Rejig of Realty Loans

The RBI, worried about soaring asset prices, has ruled out one more round of restructuring of bad real estate loans which may increase non-performing assets of banks, but bring down prices of homes as developers sell off properties to pay lenders. One more restructuring would rather be a boon for developers to hold on to prices and profit, while hurting consumers. The RBI allowed banks to restructure loans to both manufacturers and developers and continue showing bad loans as standard assets to save banks and developers from financial strain during the downturn.

**Source:** <http://economictimes.indiatimes.com/news/>

#### »» Interest Rates May Rise From Q2 of Next Fiscal: SBI

The country's largest lender State Bank of India has hinted that lending rates may rise from the second quarter of fiscal 2010-11, even though there are no immediate pressures on interest rates, which may not go up before May-June. According to the SBI, money supply is under pressure, but interest rates will remain stable in immediate future. In its recent monetary review, the RBI has asked banks to keep more cash with it, which will shrink money supply by Rs 36,000 crore from the system. The apex bank's move to hike Cash Reserve Ratio (CRR), portion of deposits banks kept in cash with the central bank, by 75 basis points to 5.75 per cent came into effect from February 13 in two portions.

**Source:** <http://economictimes.indiatimes.com/news/>

#### »» Govt Eyes Book-Building After NTPC Flop Show

Stung by a lukewarm response to the follow-on offer (FPO) from NTPC, the government is exploring the option of book-building for future divestment through FPOs instead of the auction route followed in the case of NTPC. NTPC FPO was the first ever offer for sale through this route after auction was permitted by market regulator. A final decision will be taken after the investment bankers send in their analysis of the NTPC FPO. The government has lined up an aggressive disinvestment programme for the next financial year and hopes to raise nearly Rs 30,000 crore through the process. The proposed FPOs include that of SAIL, MMTC, Hindustan Copper.

**Source:** <http://economictimes.indiatimes.com/news/>

#### »» Inflation Rises to 8.56% in January

Wholesale price-based inflation rose to 8.56 per cent in January, shooting past the RBI's forecast of 8.5 per cent for this fiscal end, as food items such as sugar, potatoes and pulses turned costlier. Overall inflation in December was 7.31 per cent. Sugar prices rose by 58.96 per cent in January year-on-year while potatoes turned costlier by 53.39 per cent and pulses by 45.64 per cent. To tame inflation, the RBI, in its quarterly monetary review, had asked banks to keep aside more cash with them.

**Source:** <http://timesofindia.indiatimes.com/biz/>

#### »» RBI Not Shying Away from Convertibility

The Reserve Bank of India (RBI) Governor Duvvuri Subbarao has said the bank was not backing away from moves towards full capital account convertibility and would rework its plans depending on global economic developments. India has been cautious on financial sector liberalisation and a move towards fuller capital account convertibility after the global financial crisis hit Asia's third-largest economy harder than expected. India has drafted a plan on fuller capital account convertibility that includes a three-phase plan extending to 2010/11 and would allow greater movement of capital in and out of the local currency.

**Source:** <http://economictimes.indiatimes.com/news/>

#### » IFAC Informs to Withdraw 2009 Third Annual Global Leadership Survey Report

The International Federation of Accountants (IFAC) has posted a notice to alert its members, recognised regional organisations, acknowledged accountancy groupings, and the public of the withdrawal of the report on the 2009 *Third Annual Global Leadership Survey*. The report was issued on January 15, 2010. The report has been withdrawn to incorporate additional responses and update the list of respondents. The report will be re-issued within the next few weeks. In case of queries or doubts, the Director of Governance and Operations Alta Prinsloo or the Deputy Director of Communications Sylvia Barrett may be contacted at [altaprinsloo@ifac.org](mailto:altaprinsloo@ifac.org) or [sylviabarrett@ifac.org](mailto:sylviabarrett@ifac.org) respectively.

Source: <http://www.ifac.org/>

#### » IPSASB Publishes Standard on Intangible Assets; Improvements to Standards

The International Public Sector Accounting Standards Board (IPSASB) has published a new International Public Sector Accounting Standard (IPSAS) that covers the accounting for and disclosure of intangible assets: IPSAS 31, *Intangible Assets*. It fills a gap in the IPSASB literature and adds some guidance on public sector-specific issues, including intangible heritage assets. It is primarily drawn from the International Accounting Standards Board's (IASB) IAS 38, *Intangible Assets*. The IPSASB has also published *Improvements to IPSASs*, to conform with minor changes to International Financial Reporting Standards (IFRSs). Both the publications can be downloaded free of charge from the site ([web.ifac.org/publications](http://web.ifac.org/publications)).

Source: <http://www.ifac.org/>

#### » IASB Issues Limited Exemption Amendment to IFRS 1

The IASB has issued a minor amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards*. The amendment relieves first-time adopters of IFRSs from providing the additional disclosures introduced in March 2009 by *Improving Disclosures about Financial Instruments* (Amendments to IFRS 7). It thereby ensures that first-time adopters benefit from the same transition provisions that Amendments to IFRS 7 provides to current IFRS preparers. The effective date of the amendment *Limited Exemption from Comparative IFRS 7 Disclosures for First-time Adopters* (Amendment to IFRS 1) is 1 July 2010, with earlier application permitted.

Source: <http://www.iasb.org/>

#### » Trustees Appoint Two Leading Financial Executives to the IASB

The Trustees of the International Accounting Standards Committee (IASC) Foundation announced today the appointment of two leading financial executives to the IASB: Dr Elke König, former member of the executive board and chief financial officer (CFO) of Hannover Re Group (Germany) and Darrel Scott, CFO of the FirstRand Banking Group (South Africa), who will begin their five-year terms as full-time members of the IASB in July and October 2010 respectively. Dr König has served as a senior financial executive in the insurance industry, while Mr Scott serves on various Governance, Risk, Operation and Strategic Committees of the Group. Mr Scott is also a member of the IASB's International Financial Reporting Interpretations Committee (IFRIC).

Source: <http://www.iasb.org/>

#### » Trustees Clarify Position on IFRS Adoption and Convergence

In a letter to the *Financial Times* that published the story, *IASB softens stance on convergence*, Chairman of the Trustees of the IASC Foundation, Gerrit Zalm, has responded to it that the constitutional emphasis on the objective of IFRS adoption globally represents a weakening of the Trustees' support for ongoing convergence efforts. He has expressed his shock over the interpretation of recent enhancements to the governance of the IASC Foundation, which, according to him, reinforce the commitment to the convergence. The Trustees strongly support the plan that the IASB has established with the US Financial Accounting Standards Board (FASB).

Source: <http://www.iasb.org/>

#### » US Economy to Keep Growing In 2010

The United States economy is expected to continue growing in 2010 despite the fragility of the global recovery, Deputy US Treasury Secretary has said recently. Growth of the world's biggest economy is expected to cool this year after a burst of activity late last year as challenges remain in bank lending and policy-making. Although the US economy faces considerable challenges due to weak recovery, it is still expected to grow by 2.9 per cent this year after an estimated contraction of 2.4 per cent in 2009. The US administration was committed to put public finances on a sustainable track in the years ahead.

Source: <http://economictimes.indiatimes.com/news/international>

#### » IASC Foundation Trustees Announce Further Governance Enhancements

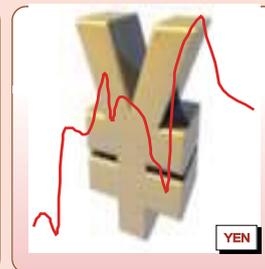
The Trustees of the IASC Foundation, the oversight body of the IASB, has announced enhancements to their governance arrangements. These changes, which are aimed at enhancing public accountability, stakeholder engagement and operational effectiveness, complete the second part of the IASC Foundation's five-yearly Constitution Review. The Trustees reached their conclusions at their meeting in Brazil on 26 and 27 January 2010. After more than a year of global public consultation, they have agreed to some major changes in the Constitution including introduction of three-yearly public consultations on the IASB's technical agenda and an emphasis on adoption of the IFRSs. The new Constitution will be put into effect on 1 March 2010.

Source: <http://www.iasb.org/News/>

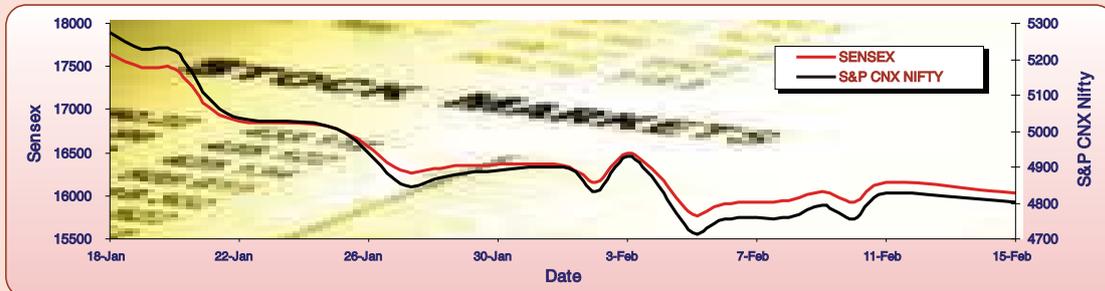
# Economic Indicators



Indian Rupee vs. Major Foreign Currencies (January 16, 2010 to February 15, 2010)



## Stock Markets



## Selected Indicators

Item	Unit/Base	2009		2010				
		Feb. 6	Jan. 1	Jan. 8	Jan. 15	Jan. 22	Jan. 29	Feb. 5
Cash Reserve Ratio	per cent	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Bank Rate	Per cent per annum	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Prime Lending Rate	Per cent per annum	11.50-12.50	11.00-12.00	11.00-12.00	11.00-12.00	11.00-12.00	11.00-12.00	11.00-12.00
Deposit Rate	Per cent per annum	7.75-9.00	6.00-7.50	6.00-7.50	6.00-7.50	6.00-7.50	6.00-7.50	6.00-7.50
Call Money Rate (Low/High)	Per cent per annum	2.00/4.50	1.90/4.50	1.50/4.50	1.00/3.40	1.00/3.50	1.00/3.35	1.00/3.40

Note: Readers are Invited to contribute write-ups or any relevant and interesting piece of information for this feature at [eboard@icai.org](mailto:eboard@icai.org).

# ACCOUNTANT'S BROWSER

## “PROFESSIONAL NEWS & VIEWS PUBLISHED ELSEWHERE”

Index of some useful articles taken from Periodicals/Newspapers received during January-February 2010 for the reference of Faculty/Students & Members of the Institute.

### 1. ACCOUNTING

Accounting for Debt Instruments Held as Assets by Edward W. Trott. *Accounting Horizons*, Vol.23/4, 2009, pp.457-469.

Accounting for Financial Instruments: Post-Crisis Changes, Part 2 by Bruce Pounder. *Strategic Finance*, January 2010, pp.17-18.

Developing an International Assurance Standard on Greenhouse Gas Statements by Roger Simnett. *Accounting Horizons*, vol.23/4, 2009, pp.347-363.

Impact of Academic Accounting Research on Professional Practice: An Analysis by the AAA Research Impact Task Force by Stephen R. Moehrle etc. *Accounting Horizons*, Vol.23/4, 2009, pp.411-456.

### 2. AUDITING

Audit Exemption: An Option for Cost-Conscious Companies? by Karen Flannery. *Accountancy Ireland*, February 2010, pp.14-16.

Audit Expectation Gap in Auditor Independence: Comparison Between India & Iran by G.H. Mahadevaswamy & M. Salehi. *Gitam Journal of Management*, January-March 2010, pp.19-38.

Auditing Complex Financial Instruments: PN 23 Increases Valuation Guidance by Patrick Connolly. *Accountancy Ireland*, February 2010, pp.12-13.

Challenges of Local Small & Medium Audit Practices by Yew Chor Heng & Lai Cheow Yee. *Singapore Accountant*, January 2010, pp.44-46.

GAAP For Private Enterprises by Stephen Spector. *CGA Magazine*, January-February 2010, pp.44-45.

Hanging in There: Despite Tough Trading Conditions, The Top 60 Firms Are Still Growing, But Only Just by Liz Fisher. *Accountancy*, January 2010, pp.22-27.

Top 60 Trainee Survey: The Next Generation by Liz Fisher. *Accountancy*, January 2010, pp.54-56.

What's Your Fraud IQ? by Andi Mcneal. *Journal of Accountancy*, January 2010, pp.34-37.

### 3. ECONOMIC

Assessment of Growth Forecasts for India by Kajal Lahiri & Prakash Loungani. *Economic & Political Weekly*, January 16, 2010, pp.61-65.

Current Macroeconomic Developments in India by Shyamala Gopinath. *RBI Bulletin*, January 2010, pp.11-21.

### 4. EDUCATION

Accreditation, Assessment & Recognition in the System of Higher Education by Dinesh Kumar Paliwal. *University News*, January 11-17, 2010, pp.7-10.

E-learning in Higher Education: Indian Perspective by Vijay Jaiswal & Priyanka Gupta. *University News*, January 18-24, 2010, pp.5-15.

Model Rules for the Right to Education Act by Archana Mehendale. *Economic & Political Weekly*, Jan. 23, 2010, pp.9-12.

Prospects & Global Challenges of Higher Education in India by M.L. Verma & P. Katiyar. *University News*, January 25-31, 2010, pp.10-16.

### 5. INVESTMENT

Asymmetric Volatility & Cross Correlations in Stock Returns Under Risk & Uncertainty by Rakesh Kumar & Raj S. Dhankar. Pp.25-36.

Business Valuation: A Critical Analysis by Arindam Ghosh & Asit Gope. *The Management Accountant*, January 2010, pp.15-18.

Mergers & Acquisitions – An empirical study on Pre & Post Acquisition Performance of Select Indian Corporate Sector Enterprises by S. Gurusamy & Radhakrishnan. *Gitam Journal of Management*, January-March 2010, pp.65-97.

Takeovers & Standard of Conduct for Directors by Rajat Sharma. *Company Law Journal*, Vol.1, 2010, pp.9-14.

### 5. LAW

Analysis of New Clauses in the Companies Bill 2009 by Vijay Kumar

Singh. *Company Law Journal*, Vol.1, 2010, pp.25-32.

Cross-Border Loss Relief for Permanent Establishments Under EC Law by Werner C. Haslehner. *Bulletin for International Taxation*, January 2010, pp.33-44.

### 6. MANAGEMENT

Brand Strategies for Globalisation by M. Yadagiri & N. Sreenivas. *Gitam Journal of Management*, January-March 2010, pp.115-128.

Corporate Governance: Selecting Your Directors, Paying Them Fairly: Looking at the Work of Nominating & Remuneration Committees by Annabelle Yip. *Singapore Accountant*, January 2010, pp.32-36.

Regulating Microfinance: A Suggested Framework by Savita Shankar & Mukul G. Asher. *Economic & Political Weekly*, January 2, 2010, pp.15-18.

### 7. TAXATION & FINANCE

Goods & Services Tax in India: An Assessment of the Base by R. Kavita Rao & Pinaki Chakraborty. *Economic & Political Weekly*, January 2, 2010, pp.49-54.

Interpretation of Tax Treaties: Myth & Reality by Brian J. Arnold. *Bulletin for International Taxation*, January 2010, pp.2-15.

Is There Tax Competition in ASEAN? by Achmad Tohari & A. Retnawati. *Bulletin for International Taxation*, January 2010, pp.51-60.

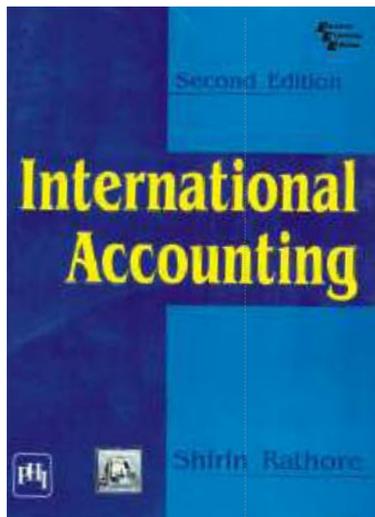
Penal Provisions: Concealment Penalty – Very Sad Development by Gopal Nathani. *Taxman*, January 2-8, 2010, pp.1-3.

Personal Financial Planning: Keeping a Bargain a Bargain by David Altro. *CA Magazine*, January-February 2010, pp.40-44.

Taxation of Mobile Activities by Steve Suarez. *Bulletin for International Taxation*, January 2010, pp.45-50.

Full Texts of the above articles are available with the Central Council Library, ICAI, which can be referred on all working days. For further inquiries please contact on 011-23370154 or by e-mail at [library@icai.org](mailto:library@icai.org)

# 'International Accounting': A Useful Book for CA Students as well as Professionals



**Title :**  
International  
Accounting  
(Second Edition)

**Author :**  
Shirin Rathore

**Pages :**  
490

**Price :**  
INR 350

**Publisher :**  
PHI Learning  
Pvt. Ltd.

The authoress has mentioned that this is a book targeted at graduate professional students. The book, however, is of tremendous interest even to the accounting professional with an academic bent of mind. The book has considerable information about the form in which the accounting profession is managed in economic powerhouses of the world on the European Continent, the North American Continent and the Far East and southern part of the Asian Landmass.

The global economy is bound to integrate even further in the future. In the past the higher levels of skill sets and education levels of western populations resulted in development and consequently wealth being generated in greater proportion in the western hemisphere post the industrial revolution. The monopolies generated by the Industrial Revolution in the western hemisphere are bound to slowly crumble in the face of the global march of education. This process is slowly leading to the development of skill sets that are in great demand within the industrial complex. The

economies of countries that are sited in the African, Asian, South American continents are growing at different rates.

In all these disparate areas dwell people with a very large difference of culture and legal systems. But the brave new world that we are progressing towards will have a tremendous demand for persons who can work in differing legal frameworks and cultural sensibilities.

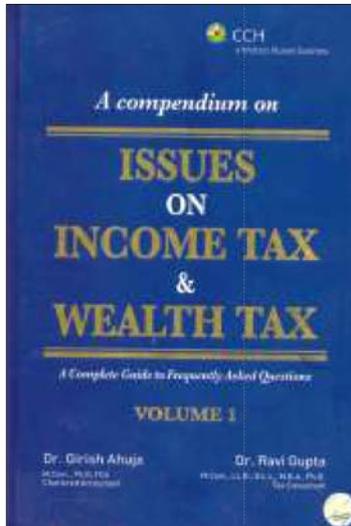
And where there is an interchange of trade and industry there is bound to be a need for accountants who can put the acts of business into a proper perspective in order that a proper appreciation of the transactions undergone can be made and stored for posterity.

Herein there is bound to be a requirement of a clearer understanding of how to account for transactions that span different continents. This book is an outstanding attempt to cover all such aspects.

The language is lucid and whilst the book is doubtless for students it is also a very handy book if the user is a professional accountant who is graying at the temples and wishes to relive the memories of days gone by; when globalisation was still a distant dream. There are quite a few examples that display the journal entries of transactions. In this age of computers when these data crunching machines can process voluminous amounts of data in the twinkling of an eye it is a pleasure to relive the days when things were a lot simpler. The reassurance is that it is still the humble journal entry that rules the roost. The mystery is the machine that encapsulates the information and regurgitates it at the press of a button. But the golden tried and tested laws of accounts still hold sway and this book is a reaffirmation of all that. All in all, a good book for the student and better for the practitioner who wishes to relive the nostalgia of old days whilst refreshing his knowledge.

*Book Reviewed by CA. Wig Sinbad, Jammu*

# A Complete Guide on Issues of Income Tax & Wealth Tax

**Title:**

A compendium on  
Issues on Income  
Tax & Wealth Tax:  
A Complete Guide to  
Frequently Asked  
Questions

**Volume I & II****Authors:**

Dr. Girish Ahuja &  
Dr. Ravi Gupta

**Pages:**

1826 in two  
volumes

**Price :**

INR 1995/-

**Publisher:**

Wolters Kluwer  
(India) Pvt. Ltd.  
New Delhi

There was a time when a good book would have lots of illustrations placed at strategic places to ensure the interest of the reader. But now we live in an age when books do not meander but come straight to the point. This tome is one of the new generation of books where the authors have compiled the entire gamut of Income Tax and Wealth Tax law in the form of Frequently Asked Questions. The Book is a remarkable compendium in that sense. The FAQ's are well arranged. The authors are noted for their brilliance. The book is a valuable addition to the library of a person who deals with the fast changing and complex field that Income Tax law and practice has evolved into.

Taxation has come a long way from the days when Kautilya wrote his treatise, *Arthashastra*. The great statesman was clear that taxes should be gathered in the manner of a honey bee gathering nectar from a flower. Today, however, taxation in India is an exceedingly complex issue. Even the legendary law-giver of western thought, Solomon would be hard pressed to deal with the issues that are raised with unflinching regularity before courts of law in our country.

The Income Tax Act probably is the most amended piece of legislation since it came onto the statute books in 1961. But then taxation law has to evolve with the times. After all, one needs to appreciate the fact that the object of taxation is to garner funds from income generating persons or enterprises. Human development has been fueled by an insatiable thirst for aggrandisement. This never ending thirst is unlikely to be slaked ever in the future. Taxes thus have to keep pace with the ever changing nature of income generating activities. The evolution of taxation law and practice has to keep pace with the extremely rapid metamorphosis that technology exerts on business stratagems and processes. The growth of the economy over the past few decades in India has been at a blistering pace. To keep pace with it is a challenge in itself. But to keep abreast and in a manner that can generate funds for the Government by taxing the shrewdest minds that exist at any point of time is the challenge before the taxing statutes. Add to that an ever growing database of case laws pronounced by the Income Tax Appellate Tribunals, High Courts and the Supreme Court on various aspects of taxation.

The above discussion will give the reader the idea that the author of any book that deals with taxation law and practice has to face in order to be able to produce a meaningful tome on Indian taxation. The authors certainly have been extremely effective in dealing with the complexities of income-tax and wealth tax law through the medium of answering queries in the form of Frequently Asked Questions.

The indexing used in the book is a great help to a person who deals with the issues that arise in Income Tax and Wealth Tax proceedings on a day-to-day basis. One can go through case laws lists and cross reference their applicability to the queries one faces in the practice of tax laws. A user can even find answers to his queries by referring to the index based on sections of the Income Tax Act. In short this is a book which is a pleasure to browse even if you do not have a specific query but just want to enhance your knowledge. ■

Book Reviewed by CA. Wig Sinbad, Jammu



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## New Releases



### e-Learning CD on Windows, Network & Wi-Fi Security–An Intro

The Committee on Information Technology, ICAI has launched e-Learning CD on Windows, Network & Wi-Fi Security–An Intro. More and more such modules are proposed to be introduced from time to time.

This e-learning module starts with an introduction to Information Systems Security concern areas in Windows, Networks & Wi-Fi, highlights needful steps and suggests the way forward.

#### Topics Covered in Network Security e-Learning Module

- ✓ Windows Security: Security threats Prevention Software, Data Back up, Encryption, Best Practices, Browser Vulnerabilities, Secure File

Deletion, Windows Vista Security, Windows Server 2008

- ✓ Network Security: Trend of Network Security, Network Security Threats, Intrusion Prevention System, Content Filtering, Network Admission Control,
- ✓ Wi-Fi Security: Introduction, Best Practices, Securing Access Point, Wi-Fi Security Audit tools, Penetration Test, Compliance Requirements

This e-learning module has been developed keeping requirement of members in general and ISA members, ICAI students, enterprises and individuals using computers/Information Systems in particular. This publication can be obtained from the Sales Counters of the Institute at Regional Offices/Head Office. It can also be obtained through post by sending a DD for the publication cost plus courier charges as indicated below in favour of "The Secretary, ICAI" payable at New Delhi to "The Postal Sales Department, The Institute of Chartered Accountants of India, A-94/4, Sector 58, Noida – 201 301, Uttar Pradesh".

**Price: Rs. 100/-, Courier Charges within Delhi & NCR Rs. 10/- and Rest of India Rs. 20/-.**



### e -Learning CD on IS Security, Cyber Threats & Review- An Intro

The Committee on Information Technology, ICAI has great pleasure in introducing e-Learning CD on "IS Security, Cyber Threats & Review – An Intro" which aims to highlight the need for IS Security considering the emerging Cyber Threats through educative content including videos.

#### Topics Covered in this e-Learning Module:

- ✓ Introduction to Cyber Threats
- ✓ Need for Securing Information Systems
- ✓ Emerging Cyber Threats
- ✓ Use of IT resources in a secure manner
- ✓ IS Security awareness

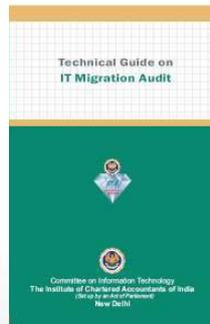
This publication can be obtained from the Sales Counters of the Institute at Regional Offices/Head Office. It can also be obtained through post by sending a DD for the publication cost plus courier charges as indicated below in favour of "The Secretary, ICAI" payable at New Delhi to "The Postal Sales Department, The Institute of Chartered Accountants of India, A-94/4, Sector 58, Noida – 201 301, Uttar Pradesh".

**Price: Rs. 100/-, Courier Charges within Delhi & NCR Rs. 10/- and Rest of India Rs. 20/-.**

## New Publications

### Technical Guide on IT Migration Audit

Pages 58 | Price: Rs. 70/-



The Committee on Information Technology has issued Technical Guide on IT Migration Audit.

#### Salient Features

- ✓ Introduction
- ✓ Migration Life Cycle
- ✓ Objectives of Migration Audit
- ✓ Pre-Migration Audit
- ✓ Post-Migration Audit
- ✓ Audit Procedures–Migration Events
- ✓ Case Studies
- ✓ Sample Checklists

This publication can be obtained from the Sales Counters of the Institute at Regional Offices/Head Office. It can also be obtained through post by sending a DD for the publication cost plus courier charges as indicated below in favour of "The Secretary, ICAI" payable at New Delhi to "The Postal Sales Department, The Institute of Chartered Accountants of India, A-94/4, Sector 58, Noida-201 301, Uttar Pradesh".

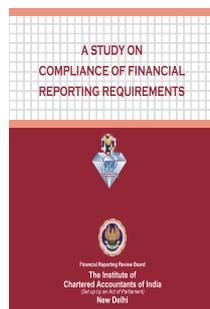
#### Courier Charges

**within Delhi & NCR** : Rs. 10/-  
**Rest of India** : Rs. 20/-

### Study on Compliance of Financial Reporting Requirements

Pages 212+ 8 initial pages+2 cover pages |

Price: Rs. 225/-



A regulatory framework – like GAAPs, apart from prescribing the regulatory requirements, have to ensure effective and efficient compliance with the prescriptions, and continuously educate all the concerned about the need of such effective and efficient compliance. The Institute of Chartered

Accountants of India through Financial Reporting Review Board (FRRB) reviews the general purpose financial statements of various enterprises and auditors report thereon in order to determine the compliance with the generally accepted accounting principles in the preparation and presentation of the financial statements; the disclosure requirements prescribed by the regulatory bodies, statutes and rules and regulations relevant to the enterprise and also the reporting obligation of the enterprise as well as the auditors.

The major non-compliances observed by the Board, since its inception, have been compiled in this publication. The basic objective of this publication is to educate the preparers of the financial statements, auditors and reviewers about the common non compliances observed in the financial reports of the enterprises, and thereby,

improving the overall quality of external financial reporting.

#### Significant Features of Study Area

- ✓ Contains more than 216 observations of the Board on compliance aspects of various Financial Reporting Requirements.
- ✓ For easy reference, the observations have been classified into the Accounting Standards, Auditing and Assurance Standards, Schedule VI to the Companies Act, 1956 and CARO, 2003.

#### Postal Charges

##### Courier:

**NCR** : Rs. 5.75/-

**Metros** : Rs. 18/-

**Other cities** : Rs. 20/-

**Registered Post** : Rs. 36/-

**Unregistered** : Rs. 19/-

##### Parcel

##### Available at:

Sales counters of the Institute of Chartered Accountants of India at New Delhi, Chennai, Mumbai, Kolkata and Kanpur.

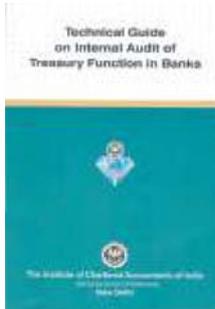
##### How to order by post:

Send a demand draft for the amount of the price of the publication (add the postal charges indicated for the desired mode of delivery) in favour of 'The Secretary, The Institute of Chartered Accountants of India' payable at New Delhi to the Postal Sales Department, The Institute of Chartered Accountants of India, ICAI Bhawan, A-94/4, Sector 58, Noida-201 301 (U.P.).

### Technical Guide on Internal Audit of Treasury Function in Banks

Pages: 106 + 20 Initial pages+ 2 cover pages

Price: Rs. 150/- (including CD)



In this financially globalised volatile times, bank's treasury groups which are ultimately responsible for keeping their banks in business are witnessing tremendous changes. Successful treasury management is extremely important for strong, viable and profitable existence of banks. Keeping this in view,

the Internal Audit Standards Board of ICAI has issued *Technical Guide on Internal Audit of Treasury Function in Banks*. Developed for the internal auditors and bankers, this publication provides practical guidance in understanding the roles and responsibilities of the treasury function in banks as well as in determining the nature of internal audit procedures to be undertaken.

#### Significant features of the Technical Guide are:

- ✓ In depth understanding of the treasury function in banks.
- ✓ Brief overview of various aspects such as treasury products and services, treasury dealing room, organisational structure of a bank's treasury, investment portfolio, asset liability management, treasury risks.

- ✓ Deals with fundamental controls and the internal audit procedures relating to treasury/ market risk segments.
- ✓ Specimen checklist for internal audit of:
  - Treasury operations
  - Foreign exchange operations of treasury
  - Domestic operations of treasury
- ✓ Includes introduction section and glossary of the terms.
- ✓ The Guide comes with a CD of the entire Guide to ensure ease of reference and reusability.

#### Ordering Information

The publication can be obtained from the sales counter at the Regional Offices or at the Head Office of the Institute. Copies can also be obtained by post. To order by post, send a demand draft for the amount of price of the publication (add the charges indicated below for the desired mode of delivery) in favour of the "The Secretary, The Institute of Chartered Accountants of India, New Delhi", payable at New Delhi, to the Postal Sales Department, The Institute of Chartered Accountants of India, A-94/4, Sector-58, Noida - 201301-(U.P.).

#### Postal Charges

By Courier:	Within Delhi	Rs. 20/-
	Rest of India	Rs. 25/-
By Registered Parcel	Within Delhi	Rs. 36/-
By Unregistered Parcel	Within Delhi	Rs. 19/-

### Classifieds

- 4771** Panchkula (Haryana) Based CA Firm With Branch At Solan (Himachal Pradesh) Seeks Professional Work On Assignment/Retainership/Sub-Contract Basis.  
Contact: 9417140128. E-mail: bmg729@yahoo.com
- 4772** Kolkata based CA firm requires partners. Retired/Lady members may also apply.  
Email to applyincafirm@gmail.com, Contact: 9831447714.
- 4773** Chennai based CA Firm requires CA's from metro cities for Partnership / Merger / Network. Having interest in work on assignments/sub-contract basis also.  
E-mail: spkca@hotmail.com Contact: 9840226799.
- 4774** Required proprietorship CA Firms exceeding 5 years old having office at locations viz. Ludhiana, Jalandhar, Bhatinda, Amritsar, Patiala, Chandigarh and Dehradun for merger and opening branch for 31 years old firm having offices at New Delhi, Kanpur & Jaipur.  
Contact : J K Sarawgi & Company,141, Siddhartha Enclave, New Delhi – 110014, 9871599182 ; jkscom@gmail.com
- 4775** CA Firm in Delhi looking for Associates (with 1-2 years experience in handling stock audits, surveys verifications) to handle various assignments in Tier II & III towns in India. Mail brief to gjai@gjai.net

## Common Proficiency Test, June, 2010

21<sup>st</sup> January, 2010

**T**he next **Common Proficiency Test (CPT) (Paper-Pencil Mode)** of the Institute will be held on **20<sup>th</sup> June, 2010** at the following centres:

**1) Centres in India:** Agra, Ahmedabad, Ahmednagar, Ajmer, Akola, Alappuzha, Aligarh, Allahabad, Alwar, Ambala, Amravati, Amritsar, Anand, Asansol, Aurangabad, Bengaluru, Bareilly, Bathinda, Beawar, Belgaum, Bellary, Berhampore, Bharuch, Bhavnagar, Bhilwara, Bhopal, Bhubaneswar, Bhuj, Bilaspur, Bikaner, Chandigarh, Chennai, Coimbatore, Cuttack, Dehradun, Delhi/New Delhi, Dhanbad, Dundlod, Durg, Ernakulam, Erode, Faridabad, Gandhidham, Ghaziabad, Goa, Gorakhpur, Guntur, Gurgaon, Guwahati, Gwalior, Hisar, Hubli, Hyderabad, Indore, Jabalpur, Jaipur, Jalandhar, Jalgaon, Jammu, Jamnagar, Jamshedpur, Jodhpur, Kanpur, Karnal, Kolhapur, Kolkata, Kollam, Kota, Kottayam, Kozhikode, Kumbakonam, Latur, Lucknow, Ludhiana, Madurai, Mangalore, Mathura, Meerut, Moradabad, Mumbai, Muzaffarnagar, Mysore, Nagpur, Nanded, Nashik, Nellore, Noida, Palghat, Pali-Marwar, Panipat, Panvel, Patiala, Patna, Pimpri-Chinchwad, Puducherry, Pune, Raipur, Rajamundry, Rajkot, Ranchi, Ratlam, Rewari, Rohtak, Rourkela, Saharanpur, Salem, Sambalpur, Sangli, Satara, Shimla, Sikar, Siliguri, Solapur, Sonapat, Sriranganagar, Surat, Thane, Thiruvananthapuram, Thrissur, Tinsukia, Tiruchirapalli, Tirupati, Tirupur, Tuticorin, Udaipur, Udupi, Ujjain, Vadodara, Vapi, Varanasi, Vellore, Vijayawada, Visakhapatnam and Yamunanagar.

**2) Overseas Centres:** Abu Dhabi, Dubai, Bahrain, Doha and Kathmandu (Nepal).

Applications for admission to Common Proficiency Test (Paper-Pencil Mode) is required to be made on the relevant prescribed form as contained in the Information Brochure, which may be obtained from the Additional Secretary (Examinations), The Institute of Chartered Accountants of India, ICAI Bhawan, Indraprastha Marg, New Delhi-110 002 on payment of Rs. 600/- (Rs. 500/- towards examination fee and Rs. 100/- towards cost of application form and Information brochure) per application form. The fee for candidates opting for Abu Dhabi, Dubai, Doha and Bahrain centres will be US \$ 160 (US \$ 150 towards examination fee and US \$ 10 towards cost of application form and information brochure) or its equivalent Indian Currency. The candidates opting for Kathmandu (Nepal) centre are required to remit

INR. 950/- (INR 850/- towards examination fee and INR 100/- towards the cost of application form and information brochure) or its equivalent foreign Currency. Since the cost of Information brochure containing Common Proficiency Test application form includes the examination fee, no separate fee is required to be remitted at the time of submitting the filled in application form. The Information brochure containing Common Proficiency Test application form will also be available in the Regional and Branch Offices of the Institute and can be obtained therefrom on cash payment on or from **6<sup>th</sup> April, 2010 to 27<sup>th</sup> April, 2010**.

Common Proficiency Test application forms duly filled in may be sent so as to reach the Additional Secretary (Examinations) at New Delhi not later than **27<sup>th</sup> April, 2010**. Applications received after **27<sup>th</sup> April, 2010** shall not be entertained under any circumstances. Applications duly filled in will be received by hand delivery at the offices of Institute at New Delhi and at the Decentralised Offices of the Institute at Mumbai, Chennai, Kolkata, Kanpur, Ahmedabad, Bengaluru, Hyderabad, Jaipur and Pune up to **27<sup>th</sup> April, 2010**. Candidates residing in these cities are advised to take advantage of this facility. It may be noted that there is no provision for acceptance of application forms after **27<sup>th</sup> April, 2010** with late fee.

Alternatively, the candidate may fill up the examination application form online at <http://icaiaexam.icaai.org> from **6<sup>th</sup> April, 2010 (10.00 hrs.) to 27<sup>th</sup> April, 2010 (17.30hrs.)** and remit the fee online by using credit card, either VISA or Master Card.

Candidates will be allowed to opt for Hindi question paper booklets for the said CPT (Paper-Pencil Mode). Further details will be available in the Information Brochure containing the application form.

Common Proficiency Test (Paper-Pencil Mode) is open only to those students who are already registered with the Institute of Chartered Accountants of India for the said course on or before **1<sup>st</sup> April, 2010** and fulfil the requisite eligibility conditions.

(G. Somasekhar)  
Additional Secretary (Exam.)

## Chartered Accountants Examinations, May, 2010

21<sup>st</sup> January, 2010

The next Professional Education–II, Professional Competence Course (PCE), Integrated Professional Competence Course (IPCE) and Final Examinations of the Institute will be held from 3<sup>rd</sup> May to 17<sup>th</sup> May, 2010 at the following centres:

**1) Centres in India:** Agra, Ahmedabad, Ahmednagar, Ajmer, Akola, Alappuzha, Aligarh, Allahabad, Alwar, Ambala, Amravati, Amritsar, Anand, Asansol, Aurangabad, Bengaluru, Bareilly, Bathinda, Beawar, Belgaum, Bellary, Berhampore, Bharuch, Bhavnagar, Bhilwara, Bhopal, Bhubaneswar, Bhuj, Bikaner, Bilaspur, Chandigarh, Chennai, Coimbatore, Cuttack, Dehradun, Delhi/New Delhi, Dhanbad, Durg, Ernakulam, Erode, Faridabad, Gandhidham, Ghaziabad, Goa, Gorakhpur, Guntur, Gurgaon, Guwahati, Gwalior, Hisar, Hubli, Hyderabad, Indore, Jabalpur, Jaipur, Jalandhar, Jalgaon, Jammu, Jamnagar, Jamshedpur, Jodhpur, Kanpur, Karnal, Kollam, Kolhapur, Kolkata, Kota, Kottayam, Kozhikode, Kumbakonam, Latur, Lucknow, Ludhiana, Madurai, Mangalore, Mathura, Meerut, Moradabad, Mumbai, Muzaffarnagar, Mysore, Nagpur, Nanded, Nashik, Nellore, Noida, Palghat, Panipat, Pali-Marwar, Panvel, Patna, Patiala, Pimpri-Chinchwad, Puducherry, Pune, Raipur, Rajamundry, Rajkot, Ranchi, Ratlam, Rewari, Rohtak, Rourkela, Saharanpur, Salem, Sambalpur, Sangli, Satara, Shimla, Sikar, Siliguri, Solapur, Sonapat, SriGanganagar, Surat, Thane, Thiruvananthapuram, Thrissur, Tinsukia, Tiruchirapalli, Tirupati, Tirupur, Tuticorin, Udaipur, Udupi, Ujjain, Vadodara, Vapi, Varanasi, Vellore, Vijayawada, Visakhapatnam and Yamunanagar.

**2) Overseas Centres:** Abu Dhabi (UAE) and Dubai (UAE) and at Kathmandu (Nepal) [ONLY FOR PE-II, PCE, IPCE AND FINAL EXAMINATIONS.]

Applications for admission to Professional Education–II, Professional Competence Course (PCE) Integrated Professional Competence Course (IPCE) and Final Examinations are required to be made in the prescribed forms. The application forms are priced at Rs. 100/- per application form and will be available for sale from 5<sup>th</sup> February, 2010. The candidates requiring forms by post may please send their requisition to the Additional Secretary (Examinations), The Institute of



Chartered Accountants of India, ICAI Bhawan, Indraprastha Marg, New Delhi–110 002, along with a remittance of Rs. 100/- per application form by Demand Draft/ Indian Postal Order, drawn in favour of the “Secretary, The Institute of Chartered Accountants of India”, payable at New Delhi giving clearly the address where the application form is required to be sent together with postal stamps worth Rs. 15/-. Alternatively the candidate may fill up the examination application form online at <http://icaiaexam.icaai.org> from 5<sup>th</sup> February, 2010 to 5<sup>th</sup> March, 2010 and remit the fee online by using credit card, either VISA or Master Card.

Management Accountancy Course (MAC Part-I), Corporate Management Course (CMC Part-I), Tax Management Course (TMC Part-I), Insurance and Risk Management (IRM) examinations will be held from 11<sup>th</sup> May, 2010 and International Trade Laws and World Trade Organisation (ITL&WTO) Examination will also be held at the centres mentioned above (except Abu Dhabi, Dubai and Kathmandu) from 4<sup>th</sup> May, 2010. For application forms for these examinations, please write to the Additional Secretary (Examinations), ICAI, New Delhi –110 002 along with a postal order/Demand Draft for Rs. 100/- drawn in favour of the Secretary, ICAI, New Delhi or obtain the same against the cash payment from Regional and Branch offices of the Institute from 5<sup>th</sup> February, 2010. The Management Accountancy Course (MAC Part-I), Corporate Management Course (CMC Part-I), Tax Management Course (TMC Part-I), Insurance and Risk Management Course (IRM) and International Trade Laws and World Trade Organisation (ITL&WTO) Examinations are open only to Members of the Institute.

The name of examination i.e. Professional Education – II, Professional Competence Course (PCE), Integrated Professional Competence Course (IPCE), Final, Management Accountancy Course (MAC Part-I),

Corporate Management Course (CMC Part-I), Tax Management Course (TMC Part-I), Insurance and Risk Management (IRM) and International Trade Laws and World Trade Organisation (ITL&WTO) examinations for which the form is required should specifically be mentioned in the requisition letter. The examination forms will be sent by ordinary post. No responsibility is taken for non/late delivery of forms by post. The forms will also be available against cash payment for personal collection at the offices of the Institute at New Delhi and its Regional and Branch Offices from 5<sup>th</sup> February, 2010. Details of date schedule of examinations will be found printed in the relevant application forms.

The Examinations will be held in ONE SESSION ONLY between 2.00 p.m. and 5.00 p.m. (IST) in respect of Professional Education-II, Professional Competence Course (PCE), Integrated Professional Competence Course (IPCE), Final, International Trade Laws and World Trade Organisation (ITL&WTO), Management Accountancy Course (MAC Part-I), Corporate Management Course (CMC Part-I), Tax

Management Course (TMC Part-I) and Insurance and Risk Management (IRM) Examinations. Details of Examination timing/session, dates of examinations, venue and sequence of papers pertaining to each examination will be found printed on the Admit Card. **There will be no change in the examination schedule in the event of any day of the examination being declared a Public Holiday by the Central Government or any State Government.**

**The last dates for receipt of application forms are 26<sup>th</sup> February, 2010 (without late fee) and 5<sup>th</sup> March, 2010 (with late fee of Rs. 500/-).**

Candidates of the Professional Education-II, Professional Competence Course (PCE), Integrated Professional Competence Course (IPCE) and Final Examinations will be allowed to opt for Hindi medium for answering questions. Further details will be available in the information sheets attached to relevant application forms.

(G. Somasekhar)  
Additional Secretary (Exams)



## For the Kind Attention of Members

RBI/2009-10/304

DNBS (PD).CC. No 167/03.10.01/2009-10

February 4, 2010

All Non-Banking Financial Companies

Dear Sir,

### **Compliance with FDI norms–Half yearly certificate from Statutory Auditors of NBFCs**

NBFCs having FDI whether under automatic route or under approval route have to comply with the stipulated minimum capitalisation norms and other relevant terms and conditions, as amended from time to time under which FDI is permitted.

2. As such these NBFCs are required to submit a certificate from their Statutory Auditors on half yearly basis (half year ending September and March) certifying compliance with the existing terms and conditions of FDI. Such certificate may be submitted not later than one month from the close of the half year to which the certificate pertains, to the Regional Office in whose jurisdiction the head office of the company is registered.

Yours faithfully,  
(A. S. Rao)  
Chief General Manager  
In-Charge

## Campus Placement Programme for Newly Qualified Chartered Accountants – March, 2010

The Committee for Members in Industry of the Institute organises Campus Placement Programme for newly qualified Chartered Accountants at various centres all over India. The scheme has been evolved to provide an opportunity both to employing organisations as well as the young professional aspirants to meet and explore the possibility of taking up positions in Industry.

### Invitation to Candidates Qualified in CA Final Examinations

It has been decided to organise Campus Placement Programme at 17 centres, viz., Ahmedabad, Bangalore, Chandigarh, Chennai, Coimbatore, Ernakulam, Hyderabad, Indore, Jaipur, Kanpur, Kolkata, Ludhiana, Mumbai, Nagpur, New Delhi, Pune & Surat in March, 2010. As earlier, a large number of leading organisations are expected to participate.

The schedule of the Campus Placement Programme is as below:

Centre	Dates of Interviews	Last date for Registration & Submitting Resume online
Bangalore, Chennai, Kolkata, Mumbai and New Delhi	4 <sup>th</sup> , 5 <sup>th</sup> , 6 <sup>th</sup> , 8 <sup>th</sup> , 9 <sup>th</sup> , 10 <sup>th</sup> March, 2010	Over
Ahmedabad, Hyderabad, Jaipur and Pune	23 <sup>rd</sup> , 25 <sup>th</sup> , 26 <sup>th</sup> March, 2010	11 <sup>th</sup> March, 2010
Chandigarh, Coimbatore, Ernakulam, Indore, Kanpur, Ludhiana, Nagpur and Surat	23 <sup>rd</sup> , 25 <sup>th</sup> , 26 <sup>th</sup> March, 2010	11 <sup>th</sup> March, 2010

### Eligibility for appearing in Campus Placement Programme to be held in March, 2010

The candidates who fulfil the following criteria are eligible to appear in the Campus Placement Programme to be held in March, 2010:

Criteria				
S. No.	Clearance of Final Examination of Chartered Accountancy Course	Completion of GMCS Course	Completion of Articledship	Submission of Application for ICAI Membership <sup>1</sup>
1	November, 2009	30 <sup>th</sup> April, 2010	30 <sup>th</sup> April, 2010	15 <sup>th</sup> May, 2010
2	June, 2009	Between 1 <sup>st</sup> November, 2009 and 30 <sup>th</sup> April, 2010	Between 1 <sup>st</sup> November, 2009 and 30 <sup>th</sup> April, 2010	

<sup>1</sup> While attending the Campus Interviews candidates should either carry the relevant proof of applying for the membership of the Institute or should submit a written declaration that they would apply for the membership by 15<sup>th</sup> May, 2010.

Please note that in cases where the candidates have qualified in **November, 2009** final examination but their articledship and/or GMCS is pending as on 30<sup>th</sup> April, 2010, they shall be permitted to appear in the Campus Placement Programme to be held in **August-September, 2010**.

While attending the Orientation Programme/Campus Interviews candidates should either carry the relevant proof of applying for the membership of the Institute or should submit a written declaration that they would apply for the membership by 15<sup>th</sup> May, 2010.

### Invitation to Employers

The Committee for Members in Industry of the Institute provides opportunity to the employers to interact with newly qualified Chartered Accountants and makes all arrangements at its centres, thereby providing a cost effective mode of recruiting newly qualified Chartered Accountants.

Organisations intending to recruit newly qualified Chartered Accountants through the above said scheme of Campus Placement Programme are requested to get in touch with Shri Shaleen Suneja, Secretary, Committee for Members in Industry, Indraprastha Marg, New Delhi-110 002, Tel. No. (011) 3011 0450/491 E-mail: [placements@icai.org](mailto:placements@icai.org), [secretarycmii@icai.in](mailto:secretarycmii@icai.in); Fax- +91(11) 30110583 (or) Mr. Ajeet Nath Tiwari, Placement Co-ordinator, at Tel +91(11) 3011 0450.

An organisation can also participate in one or more centres, as per its requirements. Firms of Chartered Accountants are also welcome to join. For further details please log on to [www.cmii.icai.org](http://www.cmii.icai.org).

**Chairman  
Committee for Members in Industry**

**Branch Notifications****(TO BE PUBLISHED IN PART III, SECTION 4 OF THE GAZETTE OF INDIA)****Notification  
(Chartered Accountants)**

February 2, 2010

No.1-CA(7)/(129) 2010

In pursuance of Regulation 159(1) of the Chartered Accountants Regulations 1988, the Council of the Institute of Chartered Accountants of India is pleased to notify the setting up of a branch of Southern India Regional Council at Tirupati with effect from January 13, 2010.

The Branch shall be known as Tirupati Branch of the Southern India Regional Council.

The jurisdiction of the Branch shall, besides Tirupati City, include the following cities/towns falling within a radius of 50 kms from the Municipal limits of Tirupati

- |                |                |              |              |                  |                   |
|----------------|----------------|--------------|--------------|------------------|-------------------|
| 1. Akanambattu | 3. Kalikini PO | 5. Nagari    | 7. Pichhatur | 9. Puttur        | 11. Rishivalli    |
| 2. Chittoor    | 4. Madanapalle | 6. Palamaner | 8. Punganur  | 10. Rachagunneri | 12. Sri Kalahasti |

As prescribed under Regulation 159(3), the Branch shall function subject to the control, supervision and directions of the Council through the Southern India Regional Council and shall carry out such directions as may, from time to time, be issued by the Council.

**(T. Karthikeyan)**  
Secretary**(TO BE PUBLISHED IN PART III, SECTION 4 OF THE GAZETTE OF INDIA)****Notification  
(Chartered Accountants)**

February 2, 2010

No.1-CA(7)/(130) 2010

In pursuance of Regulation 159(1) of the Chartered Accountants Regulations 1988, the Council of the Institute of Chartered Accountants of India is pleased to notify the setting up of a branch of Western India Regional Council at Bhavnagar with effect from January 13, 2010.

The Branch shall be known as Bhavnagar Branch of the Western India Regional Council.

The jurisdiction of the Branch shall, besides Bhavnagar City, include following the taluka falling in Bhavanagar District

- |                |            |           |               |            |
|----------------|------------|-----------|---------------|------------|
| 1. Botad       | 3. Gadhada | 5. Ghogha | 7. Gariyadhar | 9. Talaja  |
| 2. Vallabhipur | 4. Urmala  | 6. Sihor  | 8. Palitana   | 10. Mahuva |

As prescribed under Regulation 159(3), the Branch shall function subject to the control, supervision and directions of the Council through the Western India Regional Council and shall carry out such directions as may, from time to time, be issued by the Council.

**(T. Karthikeyan)**  
Secretary**(TO BE PUBLISHED IN PART III, SECTION 4 OF THE GAZETTE OF INDIA)****Notification  
(Chartered Accountants)**

February 6, 2010

No.1-CA(7)/(131) 2010

In pursuance of Regulation 159(1) of the Chartered Accountants Regulations 1988, the Council of the Institute of Chartered Accountants of India is pleased to notify the setting up of a branch of Central India Regional Council at Pali with effect from January 13, 2010.

The Branch shall be known as Pali Branch of the Central India Regional Council.

The jurisdiction of the Branch shall, besides Pali City, include the following cities/towns falling within a radius of 50 kms from the Municipal limits of Pali

- |                     |               |           |                    |            |
|---------------------|---------------|-----------|--------------------|------------|
| 1. Pali-Marwar      | 3. Sumerpur   | 5. Falana | 7. Raipur Marwar   | 9. Rohat   |
| 2. Sojat/Sojat City | 4. Sojat Road | 6. Rani   | 8. Pipaliya Kallan | 10. Marwar |

As prescribed under Regulation 159(3), the Branch shall function subject to the control, supervision and directions of the Council through the Central India Regional Council and shall carry out such directions as may, from time to time, be issued by the Council.

**(T. Karthikeyan)**  
Secretary

## Branch Notifications

...cont

**(TO BE PUBLISHED IN PART III, SECTION 4 OF THE GAZETTE OF INDIA)**  
**Notification**  
**(Chartered Accountants)**

February 9, 2010

No.1-CA(7)/(132) 2010

In pursuance of Regulation 159(1) of the Chartered Accountants Regulations 1988, the Council of the Institute of Chartered Accountants of India is pleased to notify the setting up of a branch of Central India Regional Council at Sri Ganga Nagar with effect from January 13, 2010.

The Branch shall be known as Sri Ganga Nagar Branch of the Central India Regional Council.

The jurisdiction of the Branch shall, besides Sri Ganga Nagar City, include the cities/towns falling within a radius of 50 kms from the Municipal limits of Sri Ganga Nagar.

As prescribed under Regulation 159(3), the Branch shall function subject to the control, supervision and directions of the Council through the Central India Regional Council and shall carry out such directions as may, from time to time, be issued by the Council.

**(T. Karthikeyan)**  
Secretary

**(TO BE PUBLISHED IN PART III, SECTION 4 OF THE GAZETTE OF INDIA)**

**Notification**  
**(Chartered Accountants)**

February 9, 2010

No.1-CA(7)/(133) 2010

In pursuance of Regulation 159(1) of the Chartered Accountants Regulations 1988, the Council of the Institute of Chartered Accountants of India is pleased to notify the setting up of a branch of Central India Regional Council at Ratlam with effect from January 13, 2010.

The Branch shall be known as Ratlam Branch of the Central India Regional Council.

The jurisdiction of the Branch shall, besides Ratlam District, include the cities/towns/talukas falling within the Municipal limits of Ratlam.

As prescribed under Regulation 159(3), the Branch shall function subject to the control, supervision and directions of the Council through the Central India Regional Council and shall carry out such directions as may, from time to time, be issued by the Council.

**(T. Karthikeyan)**  
Secretary

**FORM IV (SEE RULE 8)**

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I, Vijay Kapur hereby declare that the particulars given above are true to the best of my knowledge and belief.

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sd/-  
Vijay Kapur  
Signature of publisher

# Standard on Auditing (SA) 200\* (Revised) Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing

**Standard on Auditing (SA) 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, which sets out the authority of SAs.**

## Introduction

### Scope of this SA

1. This Standard on Auditing (SA) establishes the independent auditor’s overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. The independent auditor is referred to as “the auditor” hereafter.

2. SAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

### An Audit of Financial Statements

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)

4. The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. SAs do not impose responsibilities on management or those charged with governance and do not

override laws and regulations that govern their responsibilities. However, an audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. (Ref: Para. A2-A11)

5. As the basis for the auditor’s opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive. (Ref: Para. A28-A52)

6. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements<sup>1</sup>. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor’s perception of the financial information needs of users of the financial statements, and by the size or

nature of a misstatement, or a combination of both. The auditor’s opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

7. The SAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity’s internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations. (Ref: Para. A12-A13)

9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the SAs or by applicable laws or regulations<sup>2</sup>.

### Effective Date

10. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

\* The date this Revised Standard on Auditing (SA) 200 comes into effect, SA 200, “Basic Principles Governing an Audit”, issued by ICAI in April, 1985 and SA 200A, “Objective and Scope of an Audit of Financial Statements”, issued by ICAI in April, 1985 shall stand withdrawn.

† Published in the July, 2007 issue of the Journal.

<sup>1</sup> SA 320 (Revised), “Materiality in Planning and Performing an Audit” and SA 450, “Evaluation of Misstatements Identified during the Audit”.

<sup>2</sup> See, for example, SA 260 (Revised), “Communication with Those Charged with Governance”; and paragraph 43 of SA 240 (Revised), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”.

### Overall Objectives of the Auditor

11. In conducting an audit of financial statements, the overall objectives of the auditor are:

- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

12. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SAs require that the auditor disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted.

### Definitions

13. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) **Applicable financial reporting framework** – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with

the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

- (b) **Audit evidence** – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the SAs:

- (i) **Sufficiency of audit evidence** is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.
- (ii) **Appropriateness of audit evidence** is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

- (c) **Audit risk** – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

- (d) **Auditor** – "Auditor" is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant.

- (e) **Detection risk** – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

- (f) **Financial statements** – A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as

determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.

- (g) **Historical financial information** – Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

- (h) **Management** – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

- (i) **Misstatement** – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

- (j) **Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted** – That management and, where appropriate, those charged with governance have the following responsibilities that are fundamental to the conduct of an audit in accordance with SAs. That is, responsibility:

- (i) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

- (ii) To provide the auditor with:
- All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
  - Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
  - Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, the responsibility is for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework; or the preparation of financial statements that *give a true and fair view* in accordance with the financial reporting framework. This applies to all references to “preparation and presentation of the financial statements” in the SAs.

The “premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted” may also be referred to as the “premise”.

- (k) Professional judgment – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.
- (l) Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
- (m) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.
- (n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:
- Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements,

before consideration of any related controls.

- Control risk – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.
- Those charged with governance – The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

#### Requirements

##### *Ethical Requirements Relating to an Audit of Financial Statements*

14. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A14-A17)

##### *Professional Skepticism*

15. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A18-A22)

##### *Professional Judgment*

16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A23-A27)

##### *Sufficient Appropriate Audit Evidence and Audit Risk*

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion. (Ref: Para. A28-A52)

##### *Conduct of an Audit in Accordance with SAs*

##### *Complying with SAs Relevant to the Audit*

18. The auditor shall comply with all SAs relevant to the audit. An SA is relevant to the audit when the SA is in effect and the circumstances addressed by the SA exist.

(Ref: Para. A53-A56)

19. The auditor shall have an understanding of the entire text of an SA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A57-A65)

20. The auditor shall not represent compliance with SAs in the auditor’s report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit.

##### *Objectives Stated in Individual SAs*

21. To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit, having regard to the interrelationships among the SAs, to: (Ref: Para. A66-A68)

- Determine whether any audit procedures in addition to those required by the SAs are necessary in pursuance of the objectives stated in the SAs; and (Ref: Para. A69)
- Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A70)

##### *Complying with Relevant Requirements*

22. Subject to paragraph 23, the auditor shall comply with each requirement of an SA unless, in the circumstances of the audit:

- The entire SA is not relevant; or
- The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A71-A72)

23. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an SA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A73)

##### *Failure to Achieve an Objective*

24. If an objective in a relevant SA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the SAs, to modify the auditor’s opinion or withdraw from the engagement. Failure to achieve an objective represents a significant matter requiring documentation in accordance with SA 230 (Revised)<sup>3</sup>. (Ref: Para. A74-A75)

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<sup>3</sup> SA 230 (Revised), “Audit Documentation”, paragraph 8(c).

## Application and Other Explanatory Material

### An Audit of Financial Statements

#### Scope of the Audit (Ref: Para. 3)

A1. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

#### Preparation of the Financial Statements (Ref: Para. 4)

A2. An audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibility:

- (a) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (b) To provide the auditor with:
  - (i) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
  - (ii) Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
  - (iii) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

A3. As part of their responsibility for the preparation and presentation of the

financial statements, management and, where appropriate, those charged with governance are responsible for:

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- The preparation and presentation of the financial statements in accordance with that framework.
- An adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

A4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (i.e., "general purpose financial statements"); or
- The financial information needs of specific users (i.e., "special purpose financial statements").

A5. The applicable financial reporting framework often encompasses financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include:

- The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- Published accounting interpretations of varying authority issued by standards setting, professional or regulatory organisations;
- Published views of varying authority on emerging accounting issues issued by standards setting, professional or regulatory organisations;
- General and industry practices widely recognised and prevalent; and

- Accounting literature.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

A6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

A7. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. Financial reporting frameworks that encompass primarily the financial reporting standards established by an organisation that is authorised or recognised to promulgate standards to be used by entities for preparing and presenting general purpose financial statements are often designed to achieve fair presentation.

A8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the state of affairs, results of operations and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; statement of profit and loss; a cash flow statement; and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements:

- For example, normally, in government departments and local bodies, the primary financial statement is a statement of cash receipts and payments.
- Other examples of a single financial statement, each of which would include related notes, are:
  - Balance sheet.
  - Statement of profit & loss.
  - Statement of cash flows.
  - Statement of operations by product lines.

A9. SA 210 (Revised) establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting

framework<sup>4</sup>. SA 800 deals with special considerations when financial statements are prepared in accordance with a special purpose framework<sup>5</sup>.

A10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain agreement from management and, where appropriate, those charged with governance that they acknowledge and understand their responsibilities set out in paragraph A2 as a precondition for accepting the audit engagement<sup>6</sup>. The auditor is also required to obtain written representations about whether management and, where appropriate, those charged with governance have fulfilled those responsibilities<sup>7</sup>. *Considerations Specific to Central/State Governments and Related Government Entities*

A11. The mandates for audits of the financial statements of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of such an entity is conducted may include additional responsibilities, such as, the responsibility for the execution of transactions and events in accordance with legislation or proper authority.

**Form of the Auditor's Opinion** (Ref: Para. 8)

A12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable laws or regulations. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the applicable financial reporting framework includes presentation. A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the SAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the

opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the SAs to the auditor's opinion cover both forms of opinion.

**Ethical Requirements Relating to an Audit of Financial Statements** (Ref: Para. 14)

A14. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the Institute of Chartered Accountants of India. A15. The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles;

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behaviour.

A16. In the case of an audit engagement it is in the public interest and, therefore, required by the Code of Ethics, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

A17. Standard on Quality Control (SQC) 1 sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence<sup>8</sup>. Revised SA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements, determining the appropriate action if matters come to the engagement partner's attention that indicate that

members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement<sup>9</sup>. Revised SA 220 recognises that the engagement team is entitled to rely on a firm's systems in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise.

**Professional Skepticism** (Ref: Para. 15)

A18. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

A19. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

A20. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A21. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit

<sup>4</sup> SA 210 (Revised), "Agreeing the Terms of Audit Engagements", paragraph 6(a).

<sup>5</sup> SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", paragraph 8.

<sup>6</sup> SA 210 (Revised), paragraph 6(b).

<sup>7</sup> SA 580 (Revised), "Written Representations", paragraphs 10-11.

<sup>8</sup> Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements".

<sup>9</sup> SA 220 (Revised), "Quality Control for an Audit of Financial Statements".

evidence<sup>10</sup>. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter<sup>11</sup>.

A22. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

**Professional Judgment** (Ref: Para. 16)

A23. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

- Materiality and audit risk.
- The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A24. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A25. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by Revised SA 220<sup>12</sup>, assist the auditor in making informed and reasonable judgments.

A26. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

A27. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit<sup>13</sup>. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

**Sufficient Appropriate Audit Evidence and Audit Risk** (Ref: Para. 5 and 17)

**Sufficiency and Appropriateness of Audit Evidence**

A28. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit<sup>14</sup>) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that

contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

A29. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A30. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A31. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. SA 500 (Revised) and other relevant SAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

**Audit Risk**

A32. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

A33. For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation,

<sup>10</sup> SA 500 (Revised), "Audit Evidence", paragraphs 7-9.

<sup>11</sup> SA 240 (Revised), paragraph 13; SA 500 (Revised), paragraph 11; and SA 505 (Revised), "External Confirmations", paragraphs 10-11, and 16.

<sup>12</sup> See footnote 9.

<sup>13</sup> SA 230 (Revised), paragraph 8.

<sup>14</sup> SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 9.

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adverse publicity, or other events arising in connection with the audit of financial statements.

### *Risks of Material Misstatement*

A34. The risks of material misstatement may exist at two levels:

- The overall financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

A35. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

A36. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

A37. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

A38. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a

declining industry characterised by a large number of business failures.

A39. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed<sup>15</sup>.

A40. The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A41. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

### *Detection Risk*

A42. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

A43. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the

auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

A44. SA 300 (Revised)<sup>16</sup> and SA 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

### *Inherent Limitations of an Audit*

A45. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- The nature of financial reporting;
- The nature of audit procedures; and
- The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

### *The Nature of Financial Reporting*

A46. The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, the SAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to

<sup>15</sup> SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 7-17.

<sup>16</sup> SA 300 (Revised), "Planning an Audit of Financial Statements".

the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments<sup>17</sup>.

#### *The Nature of Audit Procedures*

A47. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained nor expected to be an expert in the authentication of documents.
- An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

#### *Timeliness of Financial Reporting and the Balance between Benefit and Cost*

A48. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognised in certain financial reporting frameworks (see, for example, the "Framework for the Preparation and Presentation of Financial Statements"

issued by the Institute of Chartered Accountants of India (ICAI)). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

A49. Consequently, it is necessary for the auditor to:

- Plan the audit so that it will be performed in an effective manner;
- Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- Use testing and other means of examining populations for misstatements.

A50. In light of the approaches described in paragraph A49, the SAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities<sup>18</sup>; and
- Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population<sup>19</sup>.

#### *Other Matters that Affect the Inherent Limitations of an Audit*

A51. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion. See SA 240 (Revised) for further discussion.
- The existence and completeness of related party relationships and transactions. See SA 550 (Revised)<sup>20</sup> for further discussion.
- The occurrence of non-compliance with laws and regulations. See SA 250 (Revised)<sup>21</sup> for further discussion.

- Future events or conditions that may cause an entity to cease to continue as a going concern. See SA 570 (Revised)<sup>22</sup> for further discussion.

Relevant SAs identify specific audit procedures to assist in mitigating the effect of the inherent limitations.

A52. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

#### *Conduct of an Audit in Accordance with SAs Nature of the SAs* (Ref: Para. 18)

A53. The SAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. The SAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.

A54. The scope, effective date and any specific limitation of the applicability of a specific SA is made clear in the SA. Unless otherwise stated in the SA, the auditor is permitted to apply an SA before the effective date specified therein.

A55. In performing an audit, the auditor may be required to comply with legal or regulatory requirements in addition to the SAs. The SAs do not override laws and regulations that govern an audit of financial statements. In the event that those laws and regulations differ from the SAs, an audit conducted only in accordance with laws and regulations will not automatically comply with SAs.

A56. The SAs are also relevant to engagements in case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions). The

<sup>17</sup> SA 540 (Revised), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", and SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", paragraph 12.

<sup>18</sup> SA 315, paragraphs 5-10

<sup>19</sup> SA 330; SA 500 (Revised); SA 520 (Revised), "Analytical Procedures", and SA 530 (Revised), "Audit Sampling".

<sup>20</sup> SA 550 (Revised), "Related Parties".

<sup>21</sup> SA 250 (Revised), "Consideration of Laws and Regulations in an Audit of Financial Statements".

<sup>22</sup> SA 570 (Revised), "Going Concern".

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auditor's responsibilities of those entities, however, may be affected by the audit mandate, or by obligations on those entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature, which may encompass a broader scope than an audit of financial statements in accordance with the SAs. These additional responsibilities are not dealt with in the SAs. They may be dealt with in the relevant laws and regulations in which the entities are operating.

### **Contents of the SAs** (Ref: Para. 19)

A57. In addition to objectives and requirements (requirements are expressed in the SAs using "shall"), an SA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the SA, and definitions. The entire text of an SA, therefore, is relevant to an understanding of the objectives stated in an SA and the proper application of the requirements of an SA.

A58. Where necessary, the application and other explanatory material provides further explanation of the requirements of an SA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover.
- Include examples of procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an SA. The application and other explanatory material may also provide background information on matters addressed in an SA.

A59. Appendices form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related SA or within the title and introduction of the appendix itself.

A60. Introductory material may include, as needed, such matters as explanation of:

- The purpose and scope of the SA, including how the SA relates to other SAs.
- The subject matter of the SA.
- The respective responsibilities of the auditor and others in relation to the subject matter of the SA.
- The context in which the SA is set.

A61. An SA may include, in a separate section under the heading "Definitions", a description of the meanings attributed to certain terms for purposes of the SAs. These are provided to assist in the consistent application and interpretation

of the SAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the SAs. The Glossary of Terms relating to Engagement and Quality Control Standards issued by the Auditing and Assurance Standards Board contains a complete listing of terms defined in the SAs. It also includes descriptions of other terms found in SAs to assist in common and consistent interpretation.

A62. When appropriate, additional considerations specific to audits of smaller entities and to certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), are included within the application and other explanatory material of an SA. These additional considerations assist in the application of the requirements of the SA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the SAs.

### *Considerations Specific to Smaller Entities*

A63. For purposes of specifying additional considerations to audits of smaller entities, a "smaller entity" refers to an entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
  - (i) Straightforward or uncomplicated transactions;
  - (ii) Simple record-keeping;
  - (iii) Few lines of business and few products within business lines;
  - (iv) Few internal controls;
  - (v) Few levels of management with responsibility for a broad range of controls; or
  - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

A64. The considerations specific to smaller entities included in the SAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.

A65. The SAs refer to the proprietor of a

smaller entity who is involved in running the entity on a day-to-day basis as the "owner-manager".

### **Objectives Stated in Individual SAs** (Ref: Para. 21)

A66. Each SA contains one or more objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual SAs serve to focus the auditor on the desired outcome of the SA, while being specific enough to assist the auditor in:

- Understanding what needs to be accomplished and, where necessary, the appropriate means of doing so; and
- Deciding whether more needs to be done to achieve them in the particular circumstances of the audit.

A67. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 11 of this SA. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

A68. In using the objectives, the auditor is required to have regard to the interrelationships among the SAs. This is because, as indicated in paragraph A53, the SAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this SA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each SA. At a more detailed level, SA 315 and SA 330 contain, among other things, objectives and requirements that deal with the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An SA dealing with specific aspects of the audit (for example, SA 540 (Revised)) may expand on how the objectives and requirements of such SAs as SA 315 and SA 330 are to be applied in relation to the subject of the SA but does not repeat them. Thus, in achieving the objective stated in SA 540 (Revised), the auditor has regard to the objectives and requirements of other relevant SAs.

### *Use of Objectives to Determine Need for Additional Audit Procedures* (Ref: Para. 21(a))

A69. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. The proper application of the requirements of the SAs by the auditor is

therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the SAs, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of the SAs and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by the SAs to meet the objectives specified in the SAs.

*Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence has Been Obtained* (Ref: Para. 21(b))

A70. The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 21(b):

- Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other SAs;
- Extend the work performed in applying one or more requirements; or
- Perform other procedures judged by the auditor to be necessary in the circumstances. Where none of the above is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by the SAs to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

#### **Complying with Relevant Requirements**

*Relevant Requirements* (Ref: Para. 22)

A71. In some cases, an SA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in SA 610 (Revised)<sup>23</sup> is not relevant. A72. Within a relevant SA, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor's opinion if there is a limitation

of scope<sup>24</sup> represents an explicit conditional requirement.

- The requirement to communicate significant deficiencies in internal control identified during the audit to those charged with governance<sup>25</sup>, which depends on the existence of such identified significant deficiencies; and the requirement to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework<sup>26</sup>, which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

*Departure from a Requirement* (Ref: Para. 23)

A73. SA 230 (Revised) establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement<sup>27</sup>. The SAs do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

*Failure to Achieve an Objective* (Ref: Para. 24)

A74. Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of the SAs, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in the SAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

- Prevent the auditor from complying with the relevant requirements of an SA.
- Result in its not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph 21, for example due to a limitation in the available audit evidence.

A75. Audit documentation that meets the requirements of SA 230 (Revised) and the specific documentation requirements of other relevant SAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the

auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

#### **Modifications *vis-à-vis* ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing"**

##### **Deletion**

Paragraph A11 of ISA 200 deals with the additional responsibilities for the execution of transactions and events in accordance with legislation or proper authority in case of public sector entities. Further, paragraph A57 of ISA 200 (A56 of Revised SA 200) deals with the auditor's additional responsibility arising out of the mandatory or obligatory laws or regulations applicable to that public sector entity. These additional responsibilities are not dealt by the SAs but dealt by the laws or regulations under which the public sector entity operates. Also, paragraph A63 of ISA 200 (A62 of Revised SA 200) deals with the inclusion of the paragraph specific to public sector entities in the application and explanatory material section. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of paragraphs A11, A57 and A63 in ISA, highlighting such fact, has been retained.

#### **Limited Revisions Consequential to issuance of the Standard on Auditing (SA) 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"**

The amendments to the following have been shown in track change mode.

<sup>23</sup> SA 610 (Revised), "Using the Work of Internal Auditors".

<sup>24</sup> SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 13.

<sup>25</sup> SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraph 9.

<sup>26</sup> SA 501 (Revised), "Audit Evidence – Specific Considerations for Selected Items".

<sup>27</sup> SA 230 (Revised), paragraph 12.

### Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface)

Standards issued by AASB Under the Authority of the Council of ICAI

3. The following Standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards:

...

(c) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements dealing with subject matters other than audits or reviews of historical financial information.

#### Standards on Auditing

5. The Standards on Auditing (SAs) referred to in Paragraph 3(a) above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The authority of SAs is set out in SA 200 (Revised)<sup>28</sup>.

6. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. It is undertaken to enhance the degree of confidence of intended users in the financial statements. The Standards on Auditing, taken together, provide the standards for the auditor's work in fulfilling this objective.

7. In conducting an audit, the overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor's findings. However, owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs. In all cases, when this overall objective has not been or cannot be achieved, the SAs require the auditor to modify the auditor's opinion

accordingly or withdraw from the engagement as may be appropriate, depending upon the facts and circumstances of each case.

8. The auditor applies each Standard on Auditing (SA) relevant to the audit. An SA is relevant when the SA is in effect and the circumstances addressed by the SA exist.

9. The SAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific areas. An SA contains objectives and requirements together with related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context to a proper understanding of the SAs, and definitions. It is, therefore, necessary to consider the entire text of an SA to understand and apply its requirements.

#### Objectives

10. Each SA contains an objective or objectives, which provide the context in which the requirements of the Standards on Auditing are set. Any limitation of the applicability of a specific Standard is made clear in the Standard itself. An individual Standard should be read in the context of the objective stated in the Standard as well as this Preface. The auditor aims to achieve these objectives, having regard to the interrelationships amongst the SAs. For this purpose, the auditor uses the objectives to judge whether, having complied with the requirements of the SAs, sufficient appropriate audit evidence has been obtained in the context of the overall objective of the auditor. Where an individual objective has not been or cannot be achieved, the auditor considers whether this prevents the auditor from achieving his overall objective.

#### Requirements<sup>29</sup>

11. The requirements of each SA are contained in a separate section and expressed using the word "shall". The auditor applies the requirements in the context of the other material included in the Standard.

12. The auditor complies with the requirements of an SA in all cases where they are relevant in the circumstances of the audit. In exceptional circumstances, however, the auditor may judge it

necessary to depart from a relevant requirement by performing alternate audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective.

13. When a situation envisaged in paragraph 12 above arises, the auditor is required to document how alternative procedures performed achieve the aim of the requirement, and, the reasons for the departure. Further, his report also should draw attention to such departures. However, a mere disclosure in his report does not absolve an auditor from complying with the applicable Standard(s).

14. A requirement is not relevant only in the cases where the SA is not relevant, or the circumstances envisioned do not apply because the requirement is conditional and the condition does not exist. The auditor is not required to comply with a requirement that is not relevant in the circumstances of the audit and this does not constitute a departure from the requirement. However, the auditor should document the steps undertaken by him to satisfy himself that the process adopted in the circumstances of the audit assisted him in achieving his overall objective.

#### Application and Other Explanatory Material

15. The application and other explanatory material contained in an SA is an integral part of the SA as it provides further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement.

16. Appendices, which form part of the application and other explanatory material, are an integral part of an SA. The purpose and intended use of an appendix are explained in the body of the related Standard or within the title and introduction of the appendix itself.

<sup>28</sup> SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

<sup>29</sup> The International Auditing and Assurance Standards Board, pursuant to its Clarity Project, has adopted a new format for presentation of the International Standards on Auditing (ISAs) issued by it. As per the new format, an ISA is divided into two sections, one, the requirements section and second, the application and other explanatory material section. Accordingly, the practice of presenting the standard portion (i.e., the principles enunciated) in bold lettering and the application/ explanatory guidance in plain lettering has been done away with. The entire text of the Standard, whether the requirements section or the application and other explanatory material section are presented in plain lettering.

In so far as the Auditing and Assurance Standards (AASs) issued by the Institute are concerned, in the AASs issued prior to December 1997, the entire text of the Standard is presented in the plain lettering, whereas in case of the AASs issued subsequent to that date, the standard portion/ principles enunciated are given in bold lettering whereas the explanatory/ application guidance is given in plain lettering. The presentation of the Standards on Auditing, issued subsequent to the date this Preface comes into effect, would be in line with that adopted by the IAASB for its ISAs pursuant to the Clarity Project. In the due course, the existing Standards would also be brought in line with the abovementioned convention.

### Introductory Material and Definitions

17. Introductory material may include, as needed, such matters as explanation of the purpose and scope of the Standard, including how the SA relates to other SAs, the subject matter of the SA, specific expectations from the auditor and others, and the context in which the SA is set.

18. A Standard on Auditing may include, in a separate section under the heading 'Definitions', a description of the meanings attributed to certain terms for purposes of the SAs. These are provided to assist in the consistent application and interpretation of the SAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the SAs.

### Standards on Quality Control

19. 6. SQCs are written to apply firms<sup>30</sup> in respect in respect of all their services falling under the Engagement Standards issued by the AASB of ICAI. The authority of SQCs is set out in the introduction to the SQCs.

### SA 230 (Revised), "Audit Documentation"

#### Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this SA and the specific documentation requirements of other relevant SAs provides:

- Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
- Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements...

#### Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate

effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor cannot achieve has not met or is unable to meet that would prevent the auditor from achieving the overall objectives of the auditor's overall objective...

#### Departure from a Relevant Requirement (Ref: Para. 12)

A18. The objectives and requirements of the in SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby support the achievement of the overall objectives of the auditor.<sup>7</sup> Accordingly, other than in exceptional circumstances, the SAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant<sup>8</sup> only in the cases where:

- The entire SA is not relevant [for example, if an entity does not have an internal audit function in a continuing engagement, nothing in Proposed SA 610 510 (Revised)<sup>9</sup> is relevant]; or
- The circumstances envisioned do not apply because the requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

### SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"

#### Responsibilities of the Auditor

5. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. As described in SA 200 (Revised), "Overall Objectives of the Independent Auditor and

the Conduct of an Audit in Accordance with Standards on Auditing"<sup>10</sup>, owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

6. As described in SA 200 (Revised)<sup>4</sup>, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

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

<sup>30</sup> The term "firm" refers to a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

<sup>1</sup> SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 11.

<sup>7</sup> Refer paragraph 23-24 of ISA 200 (Revised and Redrafted), SA 200 (AAS 1), "Basic Principles Governing an Audit" and SA 200A (AAS 2), "Objective and Scope of the Audit of Financial Statements". The Standards are being revised in the light of the corresponding International Standard.

<sup>8</sup> Refer paragraph 22-23 of ISA 200 (Revised and Redrafted).

<sup>9</sup> The Exposure Draft of SA 510 610 (Revised), "Initial Audit Engagements—Opening Balances Using the Work of Internal Auditors", has been published in the October, 2008 August, 2009 issue of the Journal.

<sup>3</sup> Published in the March, 2010 issue of the Journal.

<sup>4</sup> SA 200 (Revised), paragraph A51.

## STANDARDS

SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.....

### *Professional Skepticism*

12. In accordance with SA 200 (Revised)<sup>5</sup>, the auditor shall maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7-A8)

A7. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Maintaining an attitude of professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's attitude of professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's attitude of professional skepticism is particularly important in considering the risks of

material misstatement due to fraud because there may have been changes in circumstances. ....

### **SA 260 (Revised), "Communication with Those Charged with Governance"**

#### *Definitions*

6. For purposes of the SAs, the following terms have the meanings attributed below:

(a) **Those charged with governance** – The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector undertakings or an owner-manager. ~~In some cases, those charged with governance are responsible for approving<sup>7</sup> the entity's financial statements (in other cases management has this responsibility).~~ For discussion of the diversity of governance structures, see paragraphs A5-A12

b) **Management** – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager. ~~Management is responsible for the preparation of the financial statements, overseen by those charged with governance, and in some~~

~~cases management is also responsible for approving<sup>7</sup> the entity's financial statements (in other cases those charged with governance have this responsibility).~~

*Those Charged with Governance* (Ref: Para. 7)

A5. Governance structures may vary reflecting different size and ownership characteristics. For example:

- In most of the entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. In others, for example, some government undertakings a body that is not part of the entity is charged with governance.
- In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- In some cases, those charged with governance are responsible for approving<sup>5</sup> the entity's financial statements (in other cases management has this responsibility). .....

### **All Final SAs**

#### *Phrases*

"attitude of professional skepticism"

- SA 250 (Revised), paragraph 8.
- SA 540 (Revised), paragraph A40.
- SA 550 (Revised), paragraph A9.

"affected by the inherent limitations of inherent to internal control"

- SA 315, paragraph A42.

<sup>5</sup> SA 200 (Revised), paragraph 15.

<sup>3</sup> As described at paragraph [A43] of [proposed] SA 700, (hitherto known as AAS 28) "The Independent Auditor's Report on General Purpose Financial Statements". The Standard is being revised in the light of the corresponding International Standard.

<sup>4</sup> See footnote 3.

<sup>5</sup> As described at paragraph A39 of SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

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# Standard on Auditing (SA) 220(Revised)\*

## Quality Control for an Audit of Financial Statements

Standard on Auditing (SA) 220 (Revised), “Quality Control for an Audit of Financial Statements” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, which sets out the authority of SAs and SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”.

### Introduction

#### Scope of this SA

1. This Standard on Auditing (SA) deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. This SA is to be read in conjunction with relevant ethical requirements.

#### System of Quality Control and Role of Engagement Teams

2. Quality control systems, policies and procedures are the responsibility of the audit firm. Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

- (a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and
- (b) The reports issued by the firm or engagement partners are appropriate in the circumstances<sup>2</sup>

This SA is premised on the basis that the firm is subject to SQC 1. (Ref: Para. A1)

3. Within the context of the firm’s system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm’s system of quality control relating to independence.

4. Engagement teams are entitled to rely on the firm’s system of quality control, unless information provided by the firm or other parties suggests otherwise. (Ref: Para. A2)

#### Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

### Objective

6. The objective of the auditor is to

implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

- (a) The audit complies with professional standards and regulatory and legal requirements; and
- (b) The auditor’s report issued is appropriate in the circumstances.

### Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) Engagement partner – the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
- (b) Engagement quality control review – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.
- (c) Engagement quality control reviewer – a partner, other person<sup>3</sup> in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.
- (d) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

- (e) Firm – a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.
- (f) Inspection – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm’s quality control policies and procedures.
- (g) Listed entity – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.
- (h) Monitoring – a process comprising an ongoing consideration and evaluation of the firm’s system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.
- (i) Network firm – A firm or entity that belongs to a network.
- (j) Network – A larger structure:
  - (i) That is aimed at co-operation, and
  - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
- (k) Partner – any individual with authority to bind the firm with respect to the performance of a professional services engagement.
- (l) Personnel – partners and staff.
- (m) Professional Standards – Engagement Standards, as defined in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, issued by the Institute of Chartered Accountants of India and relevant ethical requirements as contained in the Code of Ethics

\* Earlier known as SA 220 (AAS 17), “Quality Control for Audit Work”.

<sup>1</sup> Published in the July, 2007 issue of the Journal.

<sup>2</sup> Standard on Quality Control (SQC) 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements”, paragraph 10.

<sup>3</sup> Such other person should be a member of the Institute of Chartered Accountants of India.

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issued by the Institute.

- (n) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise the Code of Ethics of the Institute of Chartered Accountants of India related to an audit of financial statements.
- (o) Staff – professionals, other than partners, including any experts which the firm employs.
- (p) Suitably qualified external person – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee<sup>4</sup> (with appropriate experience) of another firm.

### Requirements

#### Leadership Responsibilities for Quality on Audits

8. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. (Ref: Para. A3)

#### Relevant Ethical Requirements

9. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. (Ref: Para. A4-A5)

10. If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action. (Ref: Para. A5)

#### Independence

11. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

- (a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- (b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- (c) Take appropriate action to eliminate such threats or reduce them to an

acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. (Ref: Para. A5-A7)

#### Acceptance and Continuance of Client Relationships and Audit Engagements

12. The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8-A9)

13. If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A9)

#### Assignment of Engagement Teams

14. The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

- (a) Perform the audit engagement in accordance with professional standards and regulatory and legal requirements; and
- (b) Enable an auditor's report that is appropriate in the circumstances to be issued. (Ref: Para. A10-A12)

#### Engagement Performance

##### Direction, Supervision and Performance

15. The engagement partner shall take responsibility for:

- (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and (Ref: Para. A13-A15, A20)
- (b) The auditor's report being appropriate in the circumstances.

#### Reviews

16. The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A16-A17, A20)

17. On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement

team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A18-A20)

#### Consultation

18. The engagement partner shall:

- (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
- (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;
- (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- (d) Determine that conclusions resulting from such consultations have been implemented. (Ref: Para. A21-A22)

#### Engagement Quality Control Review

19. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

- (a) Determine that an engagement quality control reviewer has been appointed;
- (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
- (c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A23-A25)

20. The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:

- (a) Discussion of significant matters with the engagement partner;
- (b) Review of the financial statements and the proposed auditor's report;
- (c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
- (d) Evaluation of the conclusions reached

<sup>4</sup> Such employee should be a member of the Institute of Chartered Accountants of India.

in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A26- A27, A29- A31)

21. For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:
- The engagement team's evaluation of the firm's independence in relation to the audit engagement;
  - Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and
  - Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached. (Ref: Para. A28-A31)

#### Differences of Opinion

22. If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

#### Monitoring

23. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A32-A34)

#### Documentation

24. The auditor shall document:
- Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.
  - Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
  - Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
  - The nature and scope of, and conclusions resulting from, consultations undertaken during the

course of the audit engagement. (Ref: Para. A35)

25. The engagement quality control reviewer shall document, for the audit engagement reviewed, that:
- The procedures required by the firm's policies on engagement quality control review have been performed;
  - The engagement quality control review has been completed on or before the date of the auditor's report; and
  - The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

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### Application and Other Explanatory Material

#### System of Quality Control and Role of Engagement Teams (Ref: Para. 2)

A1. SQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. The system of quality control includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

#### Reliance on the Firm's System of Quality Control (Ref: Para. 4)

A2. Unless information provided by the firm or other parties suggest otherwise, the engagement team may rely on the firm's system of quality control in relation to, for example:

- Competence of personnel through their recruitment and formal training.
- Independence through the accumulation and communication of relevant independence information.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to regulatory and legal requirements through the monitoring process.

#### Leadership Responsibilities for Quality on Audits (Ref: Para. 8)

A3. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

- The importance to audit quality of:
  - Performing work that complies

with professional standards and regulatory and legal requirements;

- Complying with the firm's quality control policies and procedures as applicable;
  - Issuing auditor's reports that are appropriate in the circumstances; and
  - The engagement team's ability to raise concerns without fear of reprisals; and
- (b) The fact that quality is essential in performing audit engagements.

#### Relevant Ethical Requirements

#### Compliance with Relevant Ethical Requirements (Ref: Para. 9)

A4. The Code of Ethics issued by the Institute of Chartered Accountants of India establishes the fundamental principles of professional ethics, which include:

- Integrity;
- Objectivity;
- Professional competence and due care;
- Confidentiality; and
- Professional behaviour.

#### Definition of "Firm", "Network" and "Network Firm" (Ref: Para. 9-11)

A5. The definitions of "firm", "network" or "network firm" in relevant ethical requirements may differ from those set out in this SA. For example, the Code of Ethics of the Institute of Chartered Accountants of India (ICAI) defines the "Network Firm" as:

"Networking amongst two or more firms under common control, ownership or management with the firm or having affiliation with an accounting entity or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally".

In complying with the requirements in paragraphs 9-11, the definitions used in the relevant ethical requirements apply in so far as is necessary to interpret those ethical requirements.

#### Threats to Independence (Ref: Para. 11(c))

A6. The engagement partner may identify a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. In that case, as required by paragraph 11(c), the engagement partner reports to the relevant person(s) within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

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A7. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), statutory measures may provide safeguards for the independence of auditors of certain entities. However, such auditors or audit firms carrying out audits on behalf of the statutory auditor may, depending on the terms of the applicable legal or regulatory framework, need to adapt their approach in order to promote compliance with the spirit of paragraph 11. This may include, where the auditor's applicable law or regulation does not permit withdrawal of the auditor from the engagement, disclosure through a public report, of circumstances that have arisen that would, have otherwise lead the auditor to withdraw.

**Acceptance and Continuance of Client Relationships and Audit Engagements** (Ref: Para. 12)

A8. SQC 1 requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client<sup>5</sup>. Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

A9. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements as set out in paragraphs 12, 13 and A7 may not be relevant. Nonetheless, information gathered as a

result of the process described may be valuable to the auditors of such entities in performing risk assessments and in carrying out reporting responsibilities.

**Assignment of Engagement Teams** (Ref: Para. 14)

A10. An engagement team also includes a member using expertise in a specialised area of accounting or auditing, whether engaged or employed by the firm, if any, who performs audit procedures on the engagement.

A11. When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's:

- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and regulatory and legal requirements.
- Technical expertise, including expertise with relevant information technology and specialised areas of accounting or auditing.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

A12. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), additional appropriate competence may include skills that are necessary to discharge the terms of the audit mandate in a particular jurisdiction. Such competence may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or in the public interest. The wider scope of audit of such entities may include, for example, some aspects of performance auditing or a comprehensive assessment of compliance with legislative authorities and preventing and detecting fraud and corruption.

**Engagement Performance**

**Direction, Supervision and Performance** (Ref: Para. 15(a))

A13. Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and

perform an audit with professional skepticism as required by SA 200<sup>6</sup>.

- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.
- The objectives of the work to be performed.
- The nature of the entity's business.
- Risk-related issues.
- Problems that may arise.
- The detailed approach to the performance of the engagement.

Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.

A14. Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

A15. Supervision includes matters such as:

- Tracking the progress of the audit engagement.
- Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the audit engagement.
- Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

### Reviews

**Review Responsibilities** (Ref: Para. 16)

A16. Under SQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members<sup>7</sup>.

A17. A review consists of consideration whether, for example:

- The work has been performed in accordance with professional standards and regulatory and legal requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

<sup>5</sup> SQC 1, paragraph 28.

<sup>6</sup> SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

<sup>7</sup> SQC 1, paragraph 50.

- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

*The Engagement Partner's Review of Work Performed (Ref: Para. 17)*

A18. Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and
- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. However, as required by SA 230 (Revised), the partner documents the extent and timing of the reviews<sup>8</sup>.

A19. An engagement partner taking over an audit during the engagement may apply the review procedures as described in paragraphs A17 to review the work performed to the date of a change in order to assume the responsibilities of an engagement partner.

**Considerations Relevant Where a Member of the Engagement Team with Expertise in a Specialised Area of Accounting or Auditing Is Used (Ref: Para. 15-17)**

A20. Where a member of the engagement team with expertise in a specialised area of accounting or auditing is used, direction, supervision and review of that engagement team member's work may include matters such as:

- Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.
- Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

**Consultation (Ref: Para. 18)**

A21. Effective consultation on significant technical, ethical, and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:

- Are given all the relevant facts that will enable them to provide informed advice; and
- Have appropriate knowledge, seniority and experience.

A22. It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organisations that provide relevant quality control services.

**Engagement Quality Control Review**

*Completion of the Engagement Quality Control Review before Dating of the Auditor's Report (Ref: Para. 19(c))*

A23. SA 700 (Revised) requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements<sup>9</sup>. In cases of an audit of financial statements of

<sup>8</sup> SA 230 (Revised), "Audit Documentation", paragraph 9(c).

<sup>9</sup> SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", paragraph 41.

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listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

A24. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

A25. Completion of the engagement quality control review means the completion by the engagement quality control reviewer of the requirements in paragraphs 20-21, and where applicable, compliance with paragraph 22. Documentation of the engagement quality control review may be completed after the date of the auditor's report as part of the assembly of the final audit file. SA 230 (Revised) establishes requirements and provides guidance in this regard<sup>10</sup>.

*Nature, Extent and Timing of Engagement Quality Control Review* (Ref: Para. 20)

A26. Remaining alert for changes in circumstances allows the engagement partner to identify situations in which an engagement quality control review is necessary, even though at the start of the engagement, such a review was not required.

A27. The extent of the engagement quality control review may depend, among other things, on the complexity of the audit engagement, whether the entity is a listed entity, and the risk that the auditor's report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner for the audit engagement and its performance.

*Engagement Quality Control Review of Listed Entities* (Ref: Para. 21)

A28. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:

- Significant risks identified during the engagement in accordance with SA 315<sup>11</sup>, and the responses to those risks in accordance with SA 330<sup>12</sup>, including the engagement team's assessment of, and response to, the risk of fraud in accordance with SA 240 (Revised)<sup>13</sup>.
- Judgments made, particularly with respect to materiality and significant risks.

- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of financial statements of other entities.

*Considerations Specific to Smaller Entities* (Ref: Para. 20-21)

A29. In addition to the audits of financial statements of listed entities, an engagement quality control review is required for such audit engagements also that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review.

*Considerations Specific to Central/State Governments and Related Government Entities* (Ref: Para. 20-21)

A30. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General), may act in a role equivalent to that of engagement partner with overall responsibility for certain entities audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

A31. Certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may not necessarily be listed entities yet may be significant due to size, complexity or public interest aspects, and which consequently have a wide range of stakeholders. Examples include state owned corporations and public utilities. Ongoing transformations within the certain entities may also give rise to new types of significant entities. There are no fixed objective criteria on which the determination of significance is based. Nonetheless, auditors of such entities evaluate which of these entities may be of sufficient significance to warrant performance of an engagement quality control review.

*Monitoring* (Ref: Para. 23)

A32.SQC 1 requires the firm to establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control is relevant, adequate and operating effectively<sup>14</sup>.

A33. In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are sufficient in the context of that audit.

A34. A deficiency in the firm's system of quality control does not necessarily indicate that a particular audit engagement was not performed in accordance with professional standards and regulatory and legal requirements, or that the auditor's report was not appropriate.

*Documentation*

*Documentation of Consultations* (Ref: Para. 24(d))

A35. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

### Modifications vis-à-vis ISA 220, "Quality Control for an Audit of Financial Statements"

*Deletion*

Paragraphs A7, A9, A12, A30 and A31 of the Application Section of ISA 220 dealt with the application of the requirements of ISA 220 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that these requirements may also exist in case of non public sector entities pursuant to a requirement under the statute. Accordingly, the spirit of paragraphs A7, A9, A12, A30 and A31 has, accordingly, been made more generic in its application.

<sup>10</sup> SA 230 (Revised), paragraphs 14-16 and A21-A24.

<sup>11</sup> SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

<sup>12</sup> SA 330, "The Auditor's Responses to Assessed Risks".

<sup>13</sup> SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

<sup>14</sup> SQC 1, Paragraph 86.

# Standard on Auditing (SA) 501 (Revised)\*

## Audit Evidence — Specific Considerations for Selected Items

Standard on Auditing (SA) 501 (Revised), “Audit Evidence—Specific Considerations for Selected Items” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”<sup>1</sup>, which sets out the authority of SAs and SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”.

### Introduction

#### Scope of this SA

1. This Standard on Auditing (SA) deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330<sup>2</sup>, SA 500 (Revised)<sup>3</sup> and other relevant SAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

#### Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

### Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

- (a) Existence and condition of inventory;
- (b) Completeness of litigation and claims involving the entity; and
- (c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

### Requirements

#### Inventory

4. When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- (a) Attendance at physical inventory counting, unless impracticable, to: (Ref: Para. A1-A3)
  - (i) Evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting; (Ref: Para. A4)
  - (ii) Observe the performance of management’s count procedures; (Ref: Para. A5)
  - (iii) Inspect the inventory; and (Ref: Para. A6)

(iv) Perform test counts; and (Ref: Para. A7-A8)

(b) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.

5. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9-A11)

6. If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

7. If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor’s report in accordance with SA 705<sup>4</sup>. (Ref: Para. A12-A14)

8. When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. (Ref: Para. A15)
- (b) Perform inspection or other audit procedures appropriate in the circumstances. (Ref: Para. A16)

#### Litigation and Claims

9. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including: (Ref: Para. A17-A19)

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Reviewing legal expense accounts. (Ref: Para. A20)

10. If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity’s external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity’s external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity’s external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures. (Ref: Para. A21-A25)

11. If:

- (a) management refuses to give the auditor permission to communicate or meet with the entity’s external legal counsel, or the entity’s external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and
- (b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures,

\* Earlier known as SA 501 (AAS 34), “Audit Evidence – Additional Considerations for Specific Items”.

<sup>1</sup> Published in the July, 2007 issue of the Journal.

<sup>2</sup> SA 330, “The Auditor’s Responses to Assessed Risks”.

<sup>3</sup> SA 500 (Revised), “Audit Evidence”.

<sup>4</sup> SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”.

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the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

### Written Representations

12. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

### Segment Information

13. The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by: (Ref: Para. A26)

- (a) Obtaining an understanding of the methods used by management in determining segment information, and: (Ref: Para. A27)
  - (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
  - (ii) Where appropriate, testing the application of such methods; and
- (b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

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## Application and Other Explanatory Material

### Inventory

#### Attendance at Physical Inventory Counting (Ref: Para. 4(a))

A1. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

A2. Attendance at physical inventory counting involves:

- Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- Observing compliance with management's instructions and the performance of procedures for recording and controlling the results

- of the physical inventory count; and
- Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

A3. Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs 4-8 of this SA) include, for example:

- Nature of inventory.
- Stages of completion of work in progress.
- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate. SA 600, "Using the Work of Another Auditor"<sup>5</sup> deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regards to attendance of physical inventory counting at a remote location.
- Whether the assistance of an auditor's expert is needed. SA 620 (Revised)<sup>6</sup> deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

*Evaluate Management's Instructions and Procedures* (Ref: Para. 4(a)(i))

A4. Matters relevant in evaluating management's instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused

physical inventory count records, and count and re-count procedures.

- The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.
- The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut off date.

*Observe the Performance of Management's Count Procedures* (Ref: Para. 4(a)(ii))

A5. Observing the performance of management's count procedures, for example those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cut off information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

*Inspect the Inventory* (Ref: Para. 4(a)(iii))

A6. Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

*Perform Test Counts* (Ref: Para. 4(a)(iv))

A7. Performing test counts, for example by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records, provides audit evidence about the completeness and the accuracy of those records.

A8. In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

<sup>5</sup> The Standard is being revised in the light of the corresponding International Standard on Auditing (ISA) 600 (Revised and Redrafted), "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)". The Exposure Draft of proposed Revised SA 600 has been published in the June, 2008 issue of the Journal.

<sup>6</sup> Revised Standard on Auditing (SA) 620, "Using the Work of an Auditor's Expert".

**Physical Inventory Counting Conducted Other than At the Date of the Financial Statements** (Ref: Para. 5)

A9. For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. SA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date<sup>7</sup>.

A10. Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

A11. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

**Attendance at Physical Inventory Counting Is Impracticable** (Ref: Para. 7)

A12. In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200 (Revised)<sup>8</sup>, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

A13. In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

A14. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation<sup>9</sup>.

<sup>7</sup> SA 330, paragraphs 23-24.

<sup>8</sup> SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph A48.

<sup>9</sup> SA 705, paragraph 13.

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### **Inventory under the Custody and Control of a Third Party**

Confirmation (Ref: Para. 8(a))

A15. SA 505 (Revised)<sup>10</sup> establishes requirements and provides guidance for performing external confirmation procedures.

Other Audit Procedures (Ref: Para. 8(b))

A16. Depending on the circumstances, for example where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

### **Litigation and Claims**

#### **Completeness of Litigations and Claims** (Ref: Para. 9)

A17. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

A18. In addition to the procedures identified in paragraph 9, other relevant procedures include, for example, using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.

A19. Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. SA 540 (Revised)<sup>11</sup> establishes requirements and provides guidance relevant to the auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

Reviewing Legal Expense Accounts (Ref: Para. 9(c))

A20. Depending on the circumstances, the auditor may judge it appropriate to examine related source documents, such as invoices for legal expenses, as part of the auditor's review of legal expense accounts.

#### **Communication with the Entity's External Legal Counsel** (Ref: Para. 10-11)

A21. Direct communication with the entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reasonable.

A22. In some cases, the auditor may seek direct communication with the entity's external legal counsel through a letter of general inquiry. For this purpose, a letter of general inquiry requests the entity's external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.

A23. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

- (a) A list of litigation and claims;
- (b) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- (c) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

A24. In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

- The auditor determines that the matter is a significant risk.
- The matter is complex.
- There is disagreement between management and the entity's external legal counsel. Ordinarily, such meetings require management's

permission and are held with a representative of management in attendance.

A25. In accordance with SA 700 (Revised)<sup>12</sup>, the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.

#### **Segment Information** (Ref: Para. 13)

A26. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

#### **Understanding of the Methods Used by Management** (Ref: Para. 13(a))

A27. Depending on the circumstances, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

#### **Modifications vis-a-vis ISA 501, "Audit Evidence — Specific Considerations for Selected Items"**

The Revised SA 501, "Audit Evidence — Specific Considerations for Selected Items" does not contain any modifications vis-a-vis ISA 501.

<sup>10</sup> Revised Standard on Auditing (SA) 505, "External Confirmations".

<sup>11</sup> SA 540 (Revised), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures".

<sup>12</sup> SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", paragraph 41.

# Standard on Auditing (SA) 505 (Revised)\*

## External Confirmations

Standard on Auditing (SA) 505 (Revised), “External Confirmations” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, which sets out the authority of SAs and SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”.

### Introduction

#### Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor’s use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330<sup>2</sup> and SA 500 (Revised)<sup>3</sup>. It does not address inquiries regarding litigation and claims. SA 501 (Revised)<sup>4</sup> deals with obtaining sufficient appropriate audit evidence from such inquiries.

#### External Confirmation Procedures to Obtain Audit Evidence

2. SA 500 (Revised) indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained<sup>5</sup>. That SA also includes the following generalisations applicable to audit evidence<sup>6</sup>:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. This SA is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

3. Other SAs recognise the importance

of external confirmations as audit evidence, for example:

- SA 330 discusses the auditor’s responsibility to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level, and to design and perform further audit procedures whose nature, timing and extent are based on, and are responsive to, the assessed risks of material misstatement at the assertion level<sup>7</sup>. In addition, SA 330 requires that, irrespective of the assessed risks of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. The auditor is also required to consider whether external confirmation procedures are to be performed as substantive audit procedures<sup>8</sup>.
- SA 330 requires that the auditor obtain more persuasive audit evidence the higher the auditor’s assessment of risk<sup>9</sup>. To do this, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, or both. For example, the auditor may place more emphasis on obtaining evidence directly from third parties or obtaining corroborating evidence from a number of independent sources. SA 330 also indicates that external confirmation procedures may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material

misstatement, whether due to fraud or error<sup>10</sup>.

- SA 240 (Revised) indicates that the auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed risks of material misstatement, whether due to fraud at the assertion level<sup>11</sup>.
- SA 500 (Revised) indicates that corroborating information obtained from a source independent of the entity, such as external confirmations, may increase the assurance the auditor obtains from evidence existing within the accounting records or from the representations made by the management<sup>12</sup>.

#### Effective Date

4. This SA is effective for audit of financial statements for period beginning on or after April 1, 2010.

#### Objective

5. The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

#### Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:

- External confirmation – Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
- Positive confirmation request – A request that the confirming party

\* Earlier known as SA 505 (AAS 30), “External Confirmations”.

<sup>1</sup> Published in the July, 2007 issue of the Journal.

<sup>2</sup> SA 330, “The Auditor’s Responses to Assessed Risks”.

<sup>3</sup> SA 500 (Revised), “Audit Evidence”.

<sup>4</sup> SA 501 (Revised), “Audit Evidence—Specific Considerations for Selected Items”.

<sup>5</sup> SA 500 (Revised), paragraph A5.

<sup>6</sup> SA 500 (Revised), paragraph A31.

<sup>7</sup> SA 330, paragraphs 5-6.

<sup>8</sup> SA 330, Paragraph 20 and 20a. Paragraph 20a will be inserted in SA 330 when the final revised SA 505 comes into force.

<sup>9</sup> SA 330, paragraph 7(b).

<sup>10</sup> SA 330, paragraph A49.

<sup>11</sup> SA 240 (Revised), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, paragraph A37.

<sup>12</sup> SA 500 (Revised), paragraph A8.

respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

- c) Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
- d) Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
- e) Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

### Requirements

#### External Confirmation Procedures

7. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- (a) Determining the information to be confirmed or requested; (Ref: Para. A1)
- (b) Selecting the appropriate confirming party; (Ref: Para. A2)
- (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and (Ref: Para. A3-A6)
- (d) Sending the requests, including follow-up requests when applicable, to the confirming party. (Ref: Para. A7)

#### Management's Refusal to Allow the Auditor to Send a Confirmation Request

8. If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness; (Ref: Para. A8)
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and (Ref: Para. A9)
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence. (Ref: Para. A10)

9. If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260 (Revised)<sup>13</sup>. The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705<sup>14</sup>.

#### Results of the External Confirmation Procedures

##### Reliability of Responses to Confirmation Requests

10. If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. (Ref: Para. A11-A16)

11. If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures. (Ref: Para. A17)

##### Non-Responses

12. In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. (Ref: Para A18-A19)

##### When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence

13. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with SA 705. (Ref: Para A20)

##### Exceptions

14. The auditor shall investigate exceptions to determine whether or not they are indicative of misstatements. (Ref: Para. A21-A22)

##### Negative Confirmations

15. Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are

present: (Ref: Para. A23)

- (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
- (c) A very low exception rate is expected; and
- (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

#### Evaluating the Evidence Obtained

16. The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary. (Ref: Para A24-A25)

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### Application and Other Explanatory Material

#### External Confirmation Procedures

##### Determining the Information to be Confirmed or Requested (Ref: Para. 7(a))

A1. External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "side agreement".

##### Selecting the Appropriate Confirming Party (Ref: Para. 7(b))

A2. Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

##### Designing Confirmation Requests (Ref: Para. 7(c))

A3. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

A4. Factors to consider when designing

<sup>13</sup> SA 260 (Revised), "Communication with Those Charged with Governance", paragraph 12.

<sup>14</sup> SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

confirmation requests include:

- The assertions being addressed.
- Specific identified risks of material misstatement, including fraud risks.
- The layout and presentation of the confirmation request.
- Prior experience on the audit or similar engagements.
- The method of communication (for example, in paper form, or by electronic or other medium).
- Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

A5. A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.

A6. Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

**Follow-Up on Confirmation Requests (Ref: Para. 7(d))**

A7. The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

**Management's Refusal to Allow the Auditor to Send a Confirmation Request**

**Reasonableness of Management's Refusal (Ref: Para. 8(a))**

A8. A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation. A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

**Implications for the Assessment of Risks of Material Misstatement (Ref: Para. 8(b))**

A9. The auditor may conclude from the evaluation in paragraph 8(b) that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures in accordance with SA 315<sup>15</sup>. For example, if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240 (Revised)<sup>16</sup>.

**Alternative Audit Procedures (Ref: Para. 8(c))**

A10. The alternative audit procedures performed may be similar to those appropriate for a non-response as set out in paragraphs A18-A19 of this SA. Such procedures also would take account of the results of the auditor's evaluation in paragraph 8(b) of this SA.

**Results of the External Confirmation Procedures**

**Reliability of Responses to Confirmation Requests (Ref: Para. 10)**

A11. SA 500 (Revised) indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability<sup>17</sup>. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include that it:

- Was received by the auditor indirectly; or
- Appeared not to come from the originally intended confirming party.

A12. Responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. A process used by the auditor and the respondent that creates a secure environment for responses received electronically may mitigate these risks. If the auditor is satisfied that such a process is secure and properly controlled, the reliability of the related responses is enhanced. An electronic confirmation process might incorporate various techniques for validating the identity of a sender of information in electronic form, for example, through the use of encryption, electronic digital signatures, and procedures to verify website authenticity.

A13. If a confirming party uses a third party to coordinate and provide responses to confirmation requests, the auditor may perform procedures to address the risks that:

- (a) The response may not be from the proper source;
- (b) A respondent may not be authorised to respond; and
- (c) The integrity of the transmission may have been compromised.

A14. The auditor is required by SA 500 (Revised) to determine whether to modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence<sup>18</sup>. The auditor may choose to verify the source and contents of a response to a confirmation request by contacting the confirming party. For example, when a confirming party responds by electronic mail, the auditor may telephone the confirming party to determine whether the confirming party did, in fact, send the response. When a response has been returned to the auditor indirectly (for example, because the confirming party incorrectly addressed it to the entity rather than to the auditor), the auditor may request the confirming party to respond in writing directly to the auditor.

A15. On its own, an oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response to the auditor. However, upon obtaining an oral response to a confirmation request, the auditor may, depending on the circumstances, request the confirming party to respond in writing directly to the

<sup>15</sup> SA 315, paragraph 30.

<sup>16</sup> SA 240 (Revised), paragraph 24.

<sup>17</sup> SA 500 (Revised), paragraph A31.

<sup>18</sup> SA 500 (Revised), paragraph 11.

auditor. If no such response is received, in accordance with paragraph 12, the auditor seeks other audit evidence to support the information in the oral response.

A16. A response to a confirmation request may contain restrictive language regarding its use. Such restrictions do not necessarily invalidate the reliability of the response as audit evidence.

**Unreliable Responses** (Ref: Para. 11)

A17. When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with SA 315<sup>19</sup>. For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with SA 240 (Revised)<sup>20</sup>.

**Non-Responses** (Ref: Para. 12)

A18. Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

A19. The nature and extent of alternative audit procedures are affected by the account and assertion in question. A non-response to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level, and modify planned audit procedures, in accordance with SA 315<sup>21</sup>. For example, fewer responses to confirmation requests than anticipated, or a greater number of responses than anticipated, may indicate a previously unidentified fraud risk factor that requires evaluation in accordance with SA 240 (Revised)<sup>22</sup>.

**When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence** (Ref: Para. 13)

A20. In certain circumstances, the auditor may identify an assessed risk of material misstatement at the assertion level for which a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. Such

circumstances may include where:

- The information available to corroborate management's assertion(s) is only available outside the entity.
- Specific fraud risk factors, such as the risk of management override of controls, or the risk of collusion which can involve employee(s) and/or management, prevent the auditor from relying on evidence from the entity.

**Exceptions** (Ref: Para. 14)

A21. Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required by SA 240 (Revised) to evaluate whether such misstatement is indicative of fraud<sup>23</sup>. Exceptions may provide a guide to the quality of responses from similar confirming parties or for similar accounts. Exceptions also may indicate a deficiency, or deficiencies, in the entity's internal control over financial reporting.

A22. Some exceptions do not represent misstatements. For example, the auditor may conclude that differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the external confirmation procedures.

**Negative Confirmations** (Ref: Para. 15)

A23. The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise. For example, holders of bank deposit accounts may be more likely to respond if they believe that the balance in their account is understated in the confirmation request, but may be less likely to respond when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of bank deposit accounts may be a useful procedure in considering whether such balances may be understated, but is

unlikely to be effective if the auditor is seeking evidence regarding overstatement.

**Evaluating the Evidence Obtained** (Ref: Para. 16)

A24. When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

- (a) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;
- (b) A response deemed unreliable;
- (c) A non-response; or
- (d) A response indicating an exception.

A25. The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330<sup>24</sup>.

**Modifications vis-a-vis ISA 505, "External Confirmations"**

The Revised SA 505, "External Confirmations" does not contain any modifications vis-à-vis ISA 505.

**Limited Revisions Consequential to issuance of the Standard on Auditing (SA) 505 (Revised), "External Confirmations"**

The amendments to SA 330 have been shown in Track Changed mode.

**SA 330, "The Auditor's Responses to Assessed Risks"**

20a. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A47a-A47d)

[When the consequential limited revisions are included in SA 330, paragraph 20a will become paragraph 21 and the SA will be renumbered accordingly.]

Considering Whether External Confirmation Procedures Are to Be Performed

A47a. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external

<sup>19</sup> SA 315, paragraph 30.

<sup>20</sup> SA 240 (Revised), paragraph 24.

<sup>21</sup> SA 315, paragraph 30.

<sup>22</sup> SA 240 (Revised), paragraph 24.

<sup>23</sup> SA 240 (Revised), paragraph 35.

<sup>24</sup> SA 330, paragraphs 27-28.

confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

A47b. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.

A47c. The auditor may determine that

external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor’s decision about whether to perform external confirmation procedures.

A47d. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

- The confirming party’s knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond – for example, the confirming party:
  - ▶ May not accept responsibility for responding to a confirmation request;
  - ▶ May consider responding too costly or time consuming;
  - ▶ May have concerns about the potential legal liability resulting from responding;
  - ▶ May account for transactions in different currencies; or
  - ▶ May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- The objectivity of the intended

confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

*Substantive Procedures Responsive to Significant Risks (Ref: Para. 22)*

A49. Paragraph 22 of this SA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognising revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmations procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmations procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms. Substantive procedures related to significant risks are most often designed to obtain audit evidence with high reliability.

[When the consequential limited revisions are included in SA 330, paragraph A47a will become paragraph A48 and the SA will be renumbered accordingly.]

## Request to Contribute in the Journal

Members and other experts are requested to contribute for various sections and features of *The Chartered Accountant* journal. The write-ups covering the topical issues and latest updates will be preferred.

Every article should be of about 3000 words and shall also have an executive summary of about 100 words and complete references/bibliography of the sources referred. Please note that a declaration about originality of the article, author’s good quality passport size photograph, ICAI e-mail ID

and complete contact details (postal address and contact numbers) should also accompany the article. As a token of appreciation, an honorarium of Rs. 5000/- is payable for every article selected by the Editorial Board and published. Besides, for members of the Institute, a CPE credit of four hours is also granted.

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## Standard on Auditing (SA) 520(Revised)\*

**Standard on Auditing (SA) 520 (Revised), “Analytical Procedures” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”<sup>1</sup>, which sets out the authority of SAs and SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”.**

### Introduction

#### Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor’s use of analytical procedures as substantive procedures (“substantive analytical procedures”), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. The use of analytical procedures as risk assessment procedures is dealt with in SA 315<sup>2</sup>. SA 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures<sup>3</sup>.

#### Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

### Objectives

3. The objectives of the auditor are:

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

### Definition

4. For the purposes of the SAs, the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. The auditor’s choice of

procedures, methods and level of application is a matter of professional judgment. (Ref: Para. A1-A3)

### Requirements

#### Substantive Analytical Procedures

5. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330<sup>4</sup>, the auditor shall: (Ref: Para. A4-A5)

- (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions; (Ref: Para. A6-A11)
- (b) Evaluate the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation; (Ref: Para. A12-A14)
- (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (Ref: Para. A15)
- (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7. (Ref: Para. A16)

#### Analytical Procedures that Assist When Forming an Overall Conclusion

6. The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with

the auditor’s understanding of the entity. (Ref: Para. A17-A19)

#### Investigating Results of Analytical Procedures

7. If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (a) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses; and
- (b) Performing other audit procedures as necessary in the circumstances. (Ref: Para. A20- A21)

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### Application and Other Explanatory Material

#### Nature of Analytical Procedures (Ref: Para. 4)

A1. Analytical procedures include the consideration of comparisons of the entity’s financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity’s ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

A2. Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages.

\* Earlier known as SA 520 (AAS 14), “Analytical Procedures”.

<sup>1</sup> Published in the July, 2007 issue of the Journal.

<sup>2</sup> SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”, paragraphs 6 and A6a-A8a. Paragraphs A6a and A8a will be inserted in SA 315 when the final revised SA 520 comes into force.

<sup>3</sup> SA 330, “The Auditor’s Responses to Assessed Risks”, paragraphs 6 and 20.

<sup>4</sup> SA 330, paragraph 20.

- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

A3. Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

**Substantive Analytical Procedures** (Ref: Para. 5)

A4. The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

A5. The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

**Suitability of Particular Analytical Procedures for Given Assertions** (Ref: Para. 5(a))

A6. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

A7. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the

auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

A8. Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

A9. The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

A10. Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

*Considerations Specific to Public Sector Entities*

A11. The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public

sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalised, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometre of road construction or the number of vehicles acquired compared with vehicles retired.

**The Reliability of the Data** (Ref: Para. 5(b))

A12. The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity<sup>5</sup>;
- Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

A13. The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with

<sup>5</sup> SA 500 (Revised), "Audit Evidence", paragraph A31.

other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures<sup>6</sup>.

A14. The matters discussed in paragraphs A12(a) - A12(d) are relevant irrespective of whether the auditor performs substantive analytical procedures on the entity's period end financial statements, or at an interim date and plans to perform substantive analytical procedures for the remaining period. SA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date<sup>7</sup>.

#### **Evaluation of Whether the Expectation Is Sufficiently Precise** (Ref: Para. 5(c))

A15. Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- The availability of the information,

both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information as discussed in paragraphs A12 - A13 above.

#### **Amount of Difference of Recorded Amounts from Expected Values that Is Acceptable** (Ref: Para. 5(d))

A16. The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality<sup>8</sup> and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. SA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk<sup>9</sup>. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence<sup>10</sup>.

#### **Analytical Procedures that Assist When Forming an Overall Conclusion** (Ref: Para. 6)

A17. The conclusions drawn from the results of analytical procedures designed and performed in accordance with paragraph 6 are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

A18. The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly<sup>11</sup>.

A19. The analytical procedures performed in accordance with paragraph 6 may be similar to those that would be used as risk assessment procedures.

#### **Investigating Results of Analytical Procedures** (Ref: Para. 7)

A20. Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

A21. The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

#### **Modifications vis-a-vis ISA 520, "Analytical Procedures"**

The Revised SA 520, "Analytical Procedures" does not contain any modifications vis-à-vis ISA 520.

#### **Appendix**

##### **Analytical Procedures**

###### **Trends**

Analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.

###### **Reasonableness**

Tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts. Examples of accounts that may be reasonably tested are:

- Interest expense against interest bearing obligations
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production and raw material consumption (quantity)
- Work-in-Progress based on issued of materials and Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises

###### **Ratios**

Analysis by computation of ratios includes the study of relationships between financial statement amounts. Commonly used ratios include:

- Elements of income or loss as a percentage of sales
- Gross profit turnover

<sup>6</sup> SA 500 (Revised), paragraph 10.

<sup>7</sup> SA 330, paragraphs 23-24.

<sup>8</sup> SA 320 (Revised), "Materiality in Planning and Performing an Audit", paragraph A13.

<sup>9</sup> SA 330, paragraph 7(b).

<sup>10</sup> SA 330, paragraph A19.

<sup>11</sup> SA 315, paragraph 30.

- Accounts receivable turnover
- Inventory turnover
- Profitability, leverage, and liquidity

#### Sources of information

- Interim financial information
- Budgets
- Management accounts
- Non-financial information
- Bank and cash records
- VAT returns
- Board minutes
- Discussion or correspondence with the client at the year-end

#### Limited Revisions Consequential to issuance of the Standard on Auditing (SA) 520 (Revised), "Analytical Procedures"

The amendments to SA 315 have been shown in Track Changed mode.

#### SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"

##### Analytical Procedures

A6a. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor

was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks<sup>25</sup>. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

A7. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

A8. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration

of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures. [Proposed] ISA 520 (Redrafted) establishes requirements and provides guidance on the use of analytical procedures:

#### Considerations Specific to Smaller Entities

A8a. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

[When the consequential limited revisions are included in SA 315, paragraph A6a will become paragraph A7 and the SA will be renumbered accordingly.]

<sup>25</sup> SA 520 (Revised), "Analytical Procedures", paragraphs A1-A3 describes the nature of analytical procedures.

## CORRIGENDUM

Re: Standard on Auditing (SA) 700 (Revised), Forming an Opinion and Reporting on Financial Statements.

1. Attention of the readers is invited to Standard on Auditing (SA) 700 (Revised), Forming an Opinion and Reporting on Financial Statements published on pages 1327 – 1338 of the February 2010 issue of The Chartered Accountant. Readers are requested to read paragraph A36 of the said Standard as follows:

"A36. The report is signed by the auditor in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them<sup>25</sup>."

2. The newly inserted footnote 25 reads as under:
 

"25. The attention of the members is drawn to the decision relating to inclusion of the firm's registration number, wherever applicable, in the audit report, taken by the Council of the Institute of Chartered Accountants of India at its 292nd meeting held on January 13, 2010 and the related Announcement is published in February 2010 issue of the Journal."
3. The corrected text of the SA 700 is available on ICAI's website at the following URL: [http://www.icai.org/resource\\_file/17874sa700annx1.pdf](http://www.icai.org/resource_file/17874sa700annx1.pdf)

Inconvenience caused to the readers is regretted.

## Standard on Auditing (SA) 620 (Revised)\* Using the Work of an Auditor's Expert

Standard on Auditing (SA) 620 (Revised), "Using the Work of an Auditor's Expert" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"<sup>1</sup>, which sets out the authority of SAs and SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

### Introduction

#### Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.
2. This SA does not deal with:
  - (a) Situations where the engagement team includes a member with expertise in specialised area of accounting or auditing, which is dealt with in SA 220 (Revised)<sup>2</sup>; or
  - (b) The auditor's use of the work of an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (a management's expert), which is dealt with in SA 500 (Revised)<sup>3</sup>.

#### The Auditor's Responsibility for the Audit Opinion

3. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. Nonetheless, if the auditor using the work of an auditor's expert, having followed this SA, concludes that the work of that expert is adequate for the auditor's purposes, the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.

#### Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

### Objectives

5. The objectives of the auditor are:
  - (a) To determine whether to use the work of an auditor's expert; and
  - (b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.

### Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
  - (a) Auditor's expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. (Ref: Para. A1-A3)
  - (b) Expertise – Skills, knowledge and experience in a particular field.
  - (c) Management's expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

### Requirements

#### Determining the Need for an Auditor's Expert

7. If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert. (Ref: Para. A4-A9)

#### Nature, Timing and Extent of Audit Procedures

8. The nature, timing and extent of the auditor's procedures with respect to the requirements in paragraphs 9-13 of this SA will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including: (Ref: Para. A10)
  - (a) The nature of the matter to which that expert's work relates;
  - (b) The risks of material misstatement in the matter to which that expert's work relates;
  - (c) The significance of that expert's work in the context of the audit;

- (d) The auditor's knowledge of and experience with previous work performed by that expert; and
- (e) Whether that expert is subject to the auditor's firm's quality control policies and procedures. (Ref: Para. A11-A13)

#### The Competence, Capabilities and Objectivity of the Auditor's Expert

9. The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity. (Ref: Para. A14-A20)

#### Obtaining an Understanding of the Field of Expertise of the Auditor's Expert

10. The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to: (Ref: Para. A21-A22)
  - (a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and
  - (b) Evaluate the adequacy of that work for the auditor's purposes.

#### Agreement with the Auditor's Expert

11. The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert: (Ref: Para. A23-A26)
  - (a) The nature, scope and objectives of that expert's work; (Ref: Para. A27)
  - (b) The respective roles and responsibilities of the auditor and that expert; (Ref: Para. A28-A29)
  - (c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and (Ref: Para. A30)
  - (d) The need for the auditor's expert to observe confidentiality requirements. (Ref: Para. A31)

#### Evaluating the Adequacy of the Auditor's Expert's Work

12. The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including: (Ref: Para. A32)

\* Earlier known as SA 620 (AAS 9), "Using the Work of an Expert".

<sup>1</sup> Published in the July, 2007 issue of the Journal.

<sup>2</sup> SA 220 (Revised), "Quality Control for an Audit of Financial Statements", paragraph A20.

<sup>3</sup> SA 500 (Revised), "Audit Evidence", paragraphs A34-A48.

- (a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; (Ref: Para. A33-A34)
  - (b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and (Ref: Para. A35-A37)
  - (c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data. (Ref: Para. A38-A39)
13. If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall: (Ref: Para. A40)
- (a) Agree with that expert on the nature and extent of further work to be performed by that expert; or
  - (b) Perform further audit procedures appropriate to the circumstances.

#### *Reference to the Auditor's Expert in the Auditor's Report*

14. The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion. (Ref: Para. A41)

15. If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion. (Ref: Para. A42)

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### **Application and Other Explanatory Material**

#### *Definitions*

##### **Auditor's Expert** (Ref: Para. 6(a))

A1. Expertise in a field other than accounting or auditing may include expertise in relation to such matters as:

- The valuation of complex financial instruments, land and buildings, plant and machinery, jewellery, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
- The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
- The estimation of oil and gas reserves.
- The valuation of environmental liabilities, and site clean-up costs.
- The interpretation of contracts, laws and regulations.

- The analysis of complex or unusual tax compliance issues.

A2. In many cases, distinguishing between expertise in accounting or auditing, and expertise in another field, will be straightforward, even where this involves a specialised area of accounting or auditing. For example, an individual with expertise in applying methods of accounting for deferred income tax can often be easily distinguished from an expert in taxation law. The former is not an expert for the purposes of this SA as this constitutes accounting expertise; the latter is an expert for the purposes of this SA as this constitutes legal expertise. Similar distinctions may also be able to be made in other areas, for example, between expertise in methods of accounting for financial instruments, and expertise in complex modelling for the purpose of valuing financial instruments. In some cases, however, particularly those involving an emerging area of accounting or auditing expertise, distinguishing between specialised areas of accounting or auditing, and expertise in another field, will be a matter of professional judgment. Applicable professional rules and standards regarding education and competency requirements for accountants and auditors may assist the auditor in exercising that judgment.

A3. It is necessary to apply judgment when considering how the requirements of this SA are affected by the fact that an auditor's expert may be either an individual or an organisation. For example, when evaluating the competence, capabilities and objectivity of an auditor's expert, it may be that the expert is an organisation the auditor has previously used, but the auditor has no prior experience of the individual expert assigned by the organisation for the particular engagement; or it may be the reverse, that is, the auditor may be familiar with the work of an individual expert but not with the organisation that expert has joined. In either case, both the personal attributes of the individual and the managerial attributes of the organisation (such as systems of quality control the organisation implements) may be relevant to the auditor's evaluation.

##### *Determining the Need for an Auditor's Expert* (Ref: Para. 7)

A4. An auditor's expert may be needed to assist the auditor in one or more of the following:

- Obtaining an understanding of the entity and its environment, including its internal control.
- Identifying and assessing the risks of material misstatement.

- Determining and implementing overall responses to assessed risks at the financial statement level.
- Designing and performing further audit procedures to respond to assessed risks at the assertion level, comprising tests of controls or substantive procedures.
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements.

A5. The risks of material misstatement may increase when expertise in a field other than accounting is needed for management to prepare the financial statements, for example, because this may indicate some complexity, or because management may not possess knowledge of the field of expertise. If in preparing the financial statements management does not possess the necessary expertise, a management's expert may be used in addressing those risks. Relevant controls, including controls that relate to the work of a management's expert, if any, may also reduce the risks of material misstatement.

A6. If the preparation of the financial statements involves the use of expertise in a field other than accounting, the auditor, who is skilled in accounting and auditing, may not possess the necessary expertise to audit those financial statements. The engagement partner is required to be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement<sup>4</sup>. Further, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the engagement<sup>5</sup>. The auditor's determination of whether to use the work of an auditor's expert, and if so when and to what extent, assists the auditor in meeting these requirements. As the audit progresses, or as circumstances change, the auditor may need to revise earlier decisions about using the work of an auditor's expert.

A7. An auditor who is not an expert in a relevant field other than accounting or auditing may nevertheless be able to obtain a sufficient understanding of that field to perform the audit without an auditor's expert. This understanding may be obtained through, for example:

- Experience in auditing entities that require such expertise in the preparation of their financial statements.
- Education or professional development in the particular field. This may include formal courses, or discussion

<sup>4</sup> SA 220 (Revised), paragraph 14.

<sup>5</sup> SA 300 (Revised), "Planning an Audit of Financial Statements", paragraph 7(e).

with individuals possessing expertise in the relevant field for the purpose of enhancing the auditor's own capacity to deal with matters in that field. Such discussion differs from consultation with an auditor's expert regarding a specific set of circumstances encountered on the engagement where that expert is given all the relevant facts that will enable the expert to provide informed advice about the particular matter<sup>6</sup>.

- Discussion with auditors who have performed similar engagements.

A8. In other cases, however, the auditor may determine that it is necessary, or may choose, to use an auditor's expert to assist in obtaining sufficient appropriate audit evidence. Considerations when deciding whether to use an auditor's expert may include:

- Whether management has used a management's expert in preparing the financial statements (see paragraph A9).
- The nature and significance of the matter, including its complexity.
- The risks of material misstatement in the matter.
- The expected nature of procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts in relation to such matters; and the availability of alternative sources of audit evidence.

A9. When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- The management's expert's competence and capabilities.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- Any controls within the entity over the management's expert's work.

SA 500 (Revised)<sup>7</sup> includes requirements

and guidance regarding the effect of the competence, capabilities and objectivity of management's experts on the reliability of audit evidence.

**Nature, Timing and Extent of Audit Procedures** (Ref: Para. 8)

A10. The nature, timing and extent of audit procedures with respect to the requirements in paragraphs 9-13 of this SA will vary depending on the circumstances. For example, the following factors may suggest the need for different or more extensive procedures than would otherwise be the case:

- The work of the auditor's expert relates to a significant matter that involves subjective and complex judgments.
- The auditor has not previously used the work of the auditor's expert, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- The auditor's expert is performing procedures that are integral to the audit, rather than being consulted to provide advice on an individual matter.
- The expert is an auditor's external expert and is not, therefore, subject to the firm's quality control policies and procedures.

**The Auditor's Firm's Quality Control Policies and Procedures** (Ref: Para. 8(e))

A11. An auditor's internal expert may be a partner or staff, including temporary staff, of the auditor's firm, and therefore subject to the quality control policies and procedures of that firm in accordance with SQC 1<sup>8</sup>. Alternatively, an auditor's internal expert may be a partner or staff, including temporary staff, of a network firm, which may share common quality control policies and procedures with the auditor's firm.

A12. An auditor's external expert is not a member of the engagement team and is not subject to quality control policies and procedures in accordance with SQC 1<sup>9</sup>. Some law(s) or regulation(s), however, may require that an auditor's external expert be treated as a member of the engagement team, and may therefore be subject to relevant ethical and other professional requirements, including those relating to independence, as determined by such law(s) or regulation(s)<sup>10</sup>.

A13. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise<sup>11</sup>. The

extent of that reliance will vary with the circumstances, and may affect the nature, timing and extent of the auditor's procedures with respect to such matters as:

- Competence and capabilities, through recruitment and training programmes.
- Objectivity. Auditor's internal experts are subject to relevant ethical requirements, including those pertaining to independence.
- The auditor's evaluation of the adequacy of the auditor's expert's work. For example, the firm's training programs may provide auditor's internal experts with an appropriate understanding of the interrelationship of their expertise with the audit process. Reliance on such training and other firm processes, such as protocols for scoping the work of auditor's internal experts, may affect the nature, timing and extent of the auditor's procedures to evaluate the adequacy of the auditor's expert's work.
- Adherence to regulatory and legal requirements, through monitoring processes.
- Agreement with the auditor's expert.

Such reliance does not reduce the auditor's responsibility to meet the requirements of this SA.

**The Competence, Capabilities and Objectivity of the Auditor's Expert** (Ref: Para. 9)

A14. The competence, capabilities and objectivity of an auditor's expert are factors that significantly affect whether the work of the auditor's expert will be adequate for the auditor's purposes. Competence relates to the nature and level of expertise of the auditor's expert. Capability relates to the ability of the auditor's expert to exercise that competence in the circumstances of the engagement. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest, or the influence of others may have on the professional or business judgment of the auditor's expert.

A15. Information regarding the competence, capabilities and objectivity of an auditor's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with other auditors or

<sup>6</sup> SA 220 (Revised), paragraph A21.

<sup>7</sup> SA 500 (Revised), paragraphs 8 and A34-A48.

<sup>8</sup> SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements", paragraph 6(e).

<sup>9</sup> Proposed Revised SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements", paragraph 12 (f).

<sup>10</sup> Relevant ethical requirements ordinarily comprise the Code of Ethics of the Institute of Chartered Accountants of India related to an audit of financial statements.

<sup>11</sup> SA 220 (Revised), paragraph 4.

others who are familiar with that expert's work.

- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- The auditor's firm's quality control policies and procedures (see paragraphs A11-A13)

A16. Matters relevant to evaluating the competence, capabilities and objectivity of the auditor's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

A17. Other matters that may be relevant include:

- The relevance of the auditor's expert's competence to the matter for which that expert's work will be used, including any areas of speciality within that expert's field. For example, a particular actuary may specialise in property and casualty insurance, but have limited expertise regarding pension calculations.
- The auditor's expert's competence with respect to relevant accounting and auditing requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the auditor's expert as the audit progresses.

A18. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats, and intimidation threats. Safeguards may eliminate or reduce such threats, and may be created by external structures (for example, the auditor's expert's profession, legislation or regulation), or by the auditor's expert's work environment (for example, quality control policies and procedures). There may also be safeguards specific to the audit engagement.

A19. The evaluation of the significance of threats to objectivity and of whether there is a need for safeguards may depend upon the role of the auditor's expert and the

significance of the expert's work in the context of the audit. There may be some circumstances in which safeguards cannot reduce threats to an acceptable level, for example, if a proposed auditor's expert is an individual who has played a significant role in preparing the information that is being audited, that is, if the auditor's expert is a management's expert.

A20. When evaluating the objectivity of an auditor's external expert, it may be relevant to:

- Inquire of the entity about any known interests or relationships that the entity has with the auditor's external expert that may affect that expert's objectivity.
- Discuss with that expert any applicable safeguards, including any professional requirements that apply to that expert; and evaluate whether the safeguards are adequate to reduce threats to an acceptable level. Interests and relationships that may be relevant to discuss with the auditor's expert include:
  - Financial interests.
  - Business and personal relationships.
  - Provision of other services by the expert, including by the organisation in the case of an external expert that is an organisation.
  - In some cases, it may also be appropriate for the auditor to obtain a written representation from the auditor's external expert about any interests or relationships with the entity of which that expert is aware.

*Obtaining an Understanding of the Field of Expertise of the Auditor's Expert* (Ref: Para. 10)

A21. The auditor may obtain an understanding of the auditor's expert's field of expertise through the means described in paragraph A7, or through discussion with that expert.

A22. Aspects of the auditor's expert's field relevant to the auditor's understanding may include:

- Whether that expert's field has areas of specialty within it that are relevant to the audit (see paragraph A17).
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods, including models where applicable, are used by the auditor's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the auditor's expert uses.

*Agreement with the Auditor's Expert* (Ref: Para. 11)

A23. The nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert regardless of whether the expert is an auditor's external expert or an auditor's internal expert.

A24. The matters noted in paragraph 8 may affect the level of detail and formality of the agreement between the auditor and the auditor's expert, including whether it is appropriate that the agreement be in writing. For example, the following factors may suggest the need for more a detailed agreement than would otherwise be the case, or for the agreement to be set out in writing:

- The auditor's expert will have access to sensitive or confidential entity information.
- The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.
- Multi-jurisdictional legal or regulatory requirements apply.
- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

A25. The agreement between the auditor and an auditor's external expert is often in the form of an engagement letter. The Appendix lists matters that the auditor may consider for inclusion in such an engagement letter, or in any other form of agreement with an auditor's external expert.

A26. When there is no written agreement between the auditor and the auditor's expert, evidence of the agreement may be included in, for example:

- Planning memoranda, or related working papers such as the audit programme.
- The policies and procedures of the auditor's firm. In the case of an auditor's internal expert, the established policies and procedures to which that expert is subject may include particular policies and procedures in relation to that expert's work. The extent of documentation in the auditor's working papers depends on the nature of such policies and procedures. For example, no

documentation may be required in the auditor's working papers if the auditor's firm has detailed protocols covering the circumstances in which the work of such an expert is used.

**Nature, Scope and Objectives of Work**  
(Ref: Para. 11(a))

A27. It may often be relevant when agreeing on the nature, scope and objectives of the auditor's expert's work to include discussion of any relevant technical performance standards or other professional or industry requirements that the expert will follow.

**Respective Roles and Responsibilities** (Ref: Para. 11(b))

A28. Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may include:

- Whether the auditor or the auditor's expert will perform detailed testing of source data.
- Consent for the auditor to discuss the auditor's expert's findings or conclusions with the entity and others, and to include details of that expert's findings or conclusions in a modified auditor's report, if necessary (see paragraph A42).
- Any agreement to inform the auditor's expert of the auditor's conclusions concerning that expert's work.

**Working Papers**

A29. Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may also include agreement about access to, and retention of, each other's working papers. When the auditor's expert is a member of the engagement team, that expert's working papers form part of the audit documentation. Subject to any agreement to the contrary, auditor's external experts' working papers are their own and do not form part of the audit documentation.

**Communication** (Ref: Para. 11(c))

A30. Effective two-way communication facilitates the proper integration of the nature, timing and extent of the auditor's expert's procedures with other work on the audit, and appropriate modification of the auditor's expert's objectives during the course of the audit. For example, when the work of the auditor's expert relates to the auditor's conclusions regarding a significant risk, both a formal written report at the conclusion of that expert's work, and oral reports as the work progresses, may be appropriate. Identification of specific partners or staff who will liaise with the auditor's expert, and procedures for communication between that expert and the entity, assists timely and effective communication, particularly on larger engagements.

**Confidentiality** (Ref: Para. 11(d))

A31. It is necessary for the confidentiality provisions of relevant ethical requirements that apply to the auditor also to apply to the auditor's expert. Additional requirements may be imposed by law or regulation. The entity may also have requested that specific confidentiality provisions be agreed with auditor's external experts.

**Evaluating the Adequacy of the Auditor's Expert's Work** (Ref: Para. 12)

A32. The auditor's evaluation of the auditor's expert's competence, capabilities and objectivity, the auditor's familiarity with the auditor's expert's field of expertise, and the nature of the work performed by the auditor's expert affect the nature, timing and extent of audit procedures to evaluate the adequacy of that expert's work for the auditor's purposes.

**The Findings and Conclusions of the Auditor's Expert** (Ref: Para. 12(a))

A33. Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:

- Inquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports.
- Corroborative procedures, such as:
  - ▶ Observing the auditor's expert's work;
  - ▶ Examining published data, such as statistical reports from reputable, authoritative sources;
  - ▶ Confirming relevant matters with third parties;
  - ▶ Performing detailed analytical procedures; and
  - ▶ Re-performing calculations.
- Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
- Discussing the auditor's expert's report with management.

A34. Relevant factors when evaluating the relevance and reasonableness of the findings or conclusions of the auditor's expert, whether in a report or other form, may include whether they are:

- Presented in a manner that is consistent with any standards of the auditor's expert's profession or industry;
- Clearly expressed, including reference to the objectives agreed with the auditor, the scope of the work performed and standards applied;
- Based on an appropriate period and take into account subsequent events, where relevant;
- Subject to any reservation, limitation or restriction on use, and if so,

whether this has implications for the auditor; and

- Based on appropriate consideration of errors or deviations encountered by the auditor's expert.

**Assumptions, Methods and Source Data**

**Assumptions and Methods** (Ref: Para. 12(b))

A35. When the auditor's expert's work is to evaluate underlying assumptions and methods, including models where applicable, used by management in developing an accounting estimate, the auditor's procedures are likely to be primarily directed to evaluating whether the auditor's expert has adequately reviewed those assumptions and methods. When the auditor's expert's work is to develop an auditor's point estimate or an auditor's range for comparison with management's point estimate, the auditor's procedures may be primarily directed to evaluating the assumptions and methods, including models where appropriate, used by the auditor's expert.

A36. SA 540 (Revised)<sup>12</sup> discusses the assumptions and methods used by management in making accounting estimates, including the use in some cases of highly specialised, entity-developed models. Although that discussion is written in the context of the auditor obtaining sufficient appropriate audit evidence regarding management's assumptions and methods, it may also assist the auditor when evaluating an auditor's expert's assumptions and methods.

A37. When an auditor's expert's work involves the use of significant assumptions and methods, factors relevant to the auditor's evaluation of those assumptions and methods include whether they are:

- Generally accepted within the auditor's expert's field;
- Consistent with the requirements of the applicable financial reporting framework;
- Dependent on the use of specialised models; and
- Consistent with those of management, and if not, the reason for, and effects of, the differences.

**Source Data Used by the Auditor's Expert**  
(Ref: Para. 12(c))

A38. When an auditor's expert's work involves the use of source data that is significant to that expert's work, procedures such as the following may be used to test that data:

- Verifying the origin of the data, including obtaining an understanding of, and where applicable testing, the internal controls over the data and, where relevant, its transmission to the expert.

<sup>12</sup> SA 540 (Revised), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", paragraphs 8, 13 and 15.

- Reviewing the data for completeness and internal consistency.

A39. In many cases, the auditor may test source data. However, in other cases, when the nature of the source data used by an auditor's expert is highly technical in relation to the expert's field, that expert may test the source data. If the auditor's expert has tested the source data, inquiry of that expert by the auditor, or supervision or review of that expert's tests may be an appropriate way for the auditor to evaluate that data's relevance, completeness, and accuracy.

#### **Inadequate Work** (Ref: Para. 13)

A40. If the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures required by paragraph 13, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with SA 705 because the auditor has not obtained sufficient appropriate audit evidence<sup>19</sup>.

#### **Reference to the Auditor's Expert in the Auditor's Report** (Ref: Para. 14-15)

A41. In some cases, law or regulation may require a reference to the work of an auditor's expert, for example, for the purposes of transparency in the public sector.

A42. It may be appropriate in some circumstances to refer to the auditor's expert in an auditor's report containing a modified opinion, to explain the nature of the modification. In such circumstances, the auditor may need the permission of the auditor's expert before making such a reference.

### **Modifications vis-a-vis ISA 620, "Using the Work of an Auditor's Expert"**

The Revised SA 620, "Using the Work of an Auditor's Expert" does not contain any modifications vis-à-vis ISA 620.

## **Appendix**

(Ref: Para. A25)

### **Considerations for Agreement between the Auditor and an Auditor's External Expert**

This Appendix lists matters that the auditor may consider for inclusion in any agreement with an auditor's external expert. The following list is illustrative and is not exhaustive; it is intended only to be a guide that may be used in conjunction with the considerations outlined in this SA. Whether to include particular matters in the agreement depends on the circumstances

of the engagement. The list may also be of assistance in considering the matters to be included in an agreement with an auditor's internal expert.

#### **Nature, Scope and Objectives of the Auditor's External Expert's Work**

- The nature and scope of the procedures to be performed by the auditor's external expert.
- The objectives of the auditor's external expert's work in the context of materiality and risk considerations concerning the matter to which the auditor's external expert's work relates, and, when relevant, the applicable financial reporting framework.
- Any relevant technical performance standards or other professional or industry requirements the auditor's external expert will follow.
- The assumptions and methods, including models where applicable, the auditor's external expert will use, and their authority.
- The effective date of, or when applicable the testing period for, the subject matter of the auditor's external expert's work, and requirements regarding subsequent events.

#### **The Respective Roles and Responsibilities of the Auditor and the Auditor's External Expert**

- Relevant auditing and accounting standards, and relevant regulatory or legal requirements.
- The auditor's external expert's consent to the auditor's intended use of that expert's report, including any reference to it, or disclosure of it, to others, for example reference to it in a modified auditor's report, if necessary, or disclosure of it to management or an audit committee.
- The nature and extent of the auditor's review of the auditor's external expert's work.
- Whether the auditor or the auditor's external expert will test source data.
- The auditor's external expert's access to the entity's records, files, personnel and to experts engaged by the entity.
- Procedures for communication between the auditor's external expert and the entity.
- The auditor's and the auditor's external expert's access to each other's working papers.
- Ownership and control of working papers during and after the engagement, including any file retention requirements.
- The auditor's external expert's responsibility to perform work with due skill and care.
- The auditor's external expert's

competence and capability to perform the work.

- The expectation that the auditor's external expert will use all knowledge that expert has that is relevant to the audit or, if not, will inform the auditor.
- Any restriction on the auditor's external expert's association with the auditor's report.
- Any agreement to inform the auditor's external expert of the auditor's conclusions concerning that expert's work.

#### **Communications and Reporting**

- Methods and frequency of communications, including:
  - ▶ How the auditor's external expert's findings or conclusions will be reported (written report, oral report, ongoing input to the engagement team, etc.)
  - ▶ Identification of specific persons within the engagement team who will liaise with the auditor's external expert.
- When the auditor's external expert will complete the work and report findings or conclusions to the auditor.
- The auditor's external expert's responsibility to communicate promptly any potential delay in completing the work, and any potential reservation or limitation on that expert's findings or conclusions.
- The auditor's external expert's responsibility to communicate promptly instances in which the entity restricts that expert's access to records, files, personnel or experts engaged by the entity.
- The auditor's external expert's responsibility to communicate to the auditor all information that expert believes may be relevant to the audit, including any changes in circumstances previously communicated.
- The auditor's external expert's responsibility to communicate circumstances that may create threats to that expert's objectivity, and any relevant safeguards that may eliminate or reduce such threats to an acceptable level.

#### **Confidentiality**

- The need for the auditor's expert to observe confidentiality requirements, including:
  - ▶ The confidentiality provisions of relevant ethical requirements that apply to the auditor.
  - ▶ Additional requirements that may be imposed by law or regulation, if any.
  - ▶ Specific confidentiality provisions requested by the entity, if any.

<sup>19</sup> SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 6(b).

# Exposure Draft

## Standard on Assurance Engagements (SAE) 3000

### Assurance Engagements Other Than Audits or Reviews of Historical Financial Information

Your comments on the Exposure Draft should reach us by **April 30, 2010**. Comments are most helpful if they indicate the specific paragraph(s) to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording. The comments should be sent to:

Secretary, Auditing and Assurance Standards Board  
The Institute of Chartered Accountants of India  
ICAI Bhawan, A-94/4, Sector 58  
NOIDA, Uttar Pradesh – 201 301.

Comments can also be e-mailed at: [aasb@icai.org](mailto:aasb@icai.org)

Proposed Standard on Assurance Engagements (SAE) 3000, "Assurance Engagements Other than Audits or Reviews of Historical Financial Information" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"<sup>1</sup>, which sets out the application and authority of SAEs.

#### Introduction

1. The purpose of this Standard on Assurance Engagements (SAE) is to establish basic principles and essential procedures for, and to provide guidance to, professional accountants in public practice (for purposes of this SAE referred to as "practitioners") for the performance of assurance engagements other than audits or reviews of historical financial information covered by Standards on Auditing (SAs) or Standards on Review Engagements (SREs).

2. This SAE uses the terms "reasonable assurance engagement" and "limited assurance engagement" to distinguish between the two types of assurance engagement a practitioner is permitted to perform. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement<sup>2</sup> as the basis for a positive form of expression of the practitioner's conclusion. The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

#### Relationship with the Framework, Other SAEs, SAs and SREs

3. **The practitioner should comply with this SAE and other relevant SAEs when performing an assurance engagement other than an audit or review of historical financial information covered by SAs or SREs.** This SAE is to be read in the context of the "Framework for Assurance Engagements" (the Framework), which defines and describes the elements and objectives of an assurance engagement, and identifies those engagements to which SAEs apply. This SAE has been written for general application to assurance engagements other than audits or reviews of historical financial information covered by SAs or SREs. Other SAEs may relate to topics that apply to all subject matters or be subject matter specific. Although SAs and SREs do not apply to engagements covered by SAEs, they may nevertheless provide guidance to practitioners.

#### Ethical Requirements

4. **The practitioner should comply with the requirements of Code of Ethics of the Institute of Chartered Accountants of India.**

5. The Code provides a framework of principles that members of assurance teams, firms and network firms use to identify threats to

independence<sup>3</sup>, evaluate the significance of those threats and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level, such that independence of mind and independence in appearance are not compromised.

#### Quality Control

6. **The practitioner should implement quality control procedures that are applicable to the individual engagement.** Under Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", a firm of professional accountants has an obligation to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that the assurance reports issued by the firm or engagement partners are appropriate in the circumstances. In addition, elements of quality control that are relevant to an individual engagement include leadership responsibilities for quality on the engagement, ethical requirements, acceptance and continuance of client relationships and

<sup>1</sup> Published in July, 2007 issue of the Journal.

<sup>2</sup> Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

<sup>3</sup> If a professional accountant not in public practice, for example an internal auditor, applies SAEs, and (a) the Framework or SAEs are referred to in the professional accountant's report; and (b) the professional accountant or other members of the assurance team and, when applicable, the professional accountant's employer, are not independent of the entity in respect of which the assurance engagement is being performed, the lack of independence and the nature of the relationship(s) with the assurance client are prominently disclosed in the professional accountant's report. Also, that report does not include the word "independent" in its title, and the purpose and users of the report are restricted.

specific engagements, assignment of engagement teams, engagement performance, and monitoring.

### Engagement Acceptance and Continuance

**7. The practitioner should accept (or continue where applicable) an assurance engagement only if the subject matter is the responsibility of a party other than the intended users or the practitioner.** As indicated in paragraph 26 of the Framework, the responsible party can be one of the intended users, but not the only one. Acknowledgement by the responsible party provides evidence that the appropriate relationship exists, and also establishes a basis for a common understanding of the responsibility of each party. A written acknowledgement is the most appropriate form of documenting the responsible party's understanding. In the absence of an acknowledgement of responsibility, the practitioner considers:

- (a) Whether it is appropriate to accept the engagement. Accepting it may be appropriate when, for example, other sources, such as legislation or a contract, indicate responsibility; and
- (b) If the engagement is accepted, whether to disclose these circumstances in the assurance report.

**8. The practitioner should accept (or continue where applicable) an assurance engagement only if, on the basis of a preliminary knowledge of the engagement circumstances, nothing comes to the attention of the practitioner to indicate that the requirements of the Code or of the SAEs will not be satisfied.** The practitioner considers the matters in paragraph 16 of the Framework and does not accept the engagement unless it exhibits all the characteristics required in that paragraph. Also, if the party engaging the practitioner (the "engaging party") is not the responsible party, the practitioner considers the effect of this on access to records, documentation and other information the practitioner may require to complete the engagement.

**9. The practitioner should accept (or continue where applicable) an assurance engagement only if the practitioner is satisfied that those persons who are to perform the engagement collectively possess the necessary professional competencies.** A practitioner may be requested to perform assurance engagements on a wide range of subject matters. Some subject matters may require specialized skills

and knowledge beyond those ordinarily possessed by an individual practitioner (see paragraphs 26-32).

### Agreeing on the Terms of the Engagement

**10. The practitioner should agree on the terms of the engagement with the engaging party.** To avoid misunderstandings, the agreed terms are recorded in an engagement letter or other suitable form of contract. If the engaging party is not the responsible party, the nature and content of an engagement letter or contract may vary. The existence of a legislative mandate may satisfy the requirement to agree on the terms of the engagement. Even in those situations an engagement letter may be useful for both the practitioner and engaging party.

**11. A practitioner should consider the appropriateness of a request, made before the completion of an assurance engagement, to change the engagement to a non assurance engagement or from a reasonable assurance engagement to a limited assurance engagement, and should not agree to a change without reasonable justification.** A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, ordinarily will justify a request for a change in the engagement. If such a change is made, the practitioner does not disregard evidence that was obtained prior to the change.

### Planning and Performing the Engagement

**12. The practitioner should plan the engagement so that it will be performed effectively.** Planning involves developing an overall strategy for the scope, emphasis, timing and conduct of the engagement, and an engagement plan, consisting of a detailed approach for the nature, timing and extent of evidence-gathering procedures to be performed and the reasons for selecting them. Adequate planning helps to devote appropriate attention to important areas of the engagement, identify potential problems on a timely basis and properly organise and manage the engagement in order for it to be performed in an effective and efficient manner. Adequate planning also assists the practitioner to properly assign work to engagement team members, and facilitates their direction and supervision and the review of their work. Further, it assists, where applicable, the co-ordination of work done by other practitioners and experts. The nature and extent of

planning activities will vary with the engagement circumstances, for example the size and complexity of the entity and the practitioner's previous experience with it. Examples of the main matters to be considered include:

- The terms of the engagement.
- The characteristics of the subject matter and the identified criteria.
- The engagement process and possible sources of evidence.
- The practitioner's understanding of the entity and its environment, including the risks that the subject matter information may be materially misstated.
- Identification of intended users and their needs, and consideration of materiality and the components of assurance engagement risk.
- Personnel and expertise requirements, including the nature and extent of experts' involvement.

13. Planning is not a discrete phase, but rather a continual and iterative process throughout the engagement. As a result of unexpected events, changes in conditions, or the evidence obtained from the results of evidence-gathering procedures, the practitioner may need to revise the overall strategy and engagement plan, and thereby the resulting planned nature, timing and extent of further procedures.

**14. The practitioner should plan and perform an engagement with an attitude of professional skepticism recognising that circumstances may exist that cause the subject matter information to be materially misstated.** An attitude of professional skepticism means the practitioner makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party.

**15. The practitioner should obtain an understanding of the subject matter and other engagement circumstances, sufficient to identify and assess the risks of the subject matter information being materially misstated, and sufficient to design and perform further evidence-gathering procedures.**

16. Obtaining an understanding of the subject matter and other engagement circumstances is an essential part of planning and performing an assurance engagement. That understanding provides the practitioner with a frame of reference for exercising professional judgment throughout the engagement, for example when:

- Considering the characteristics of the subject matter;

- Assessing the suitability of criteria;
- Identifying where special consideration may be necessary, for example factors indicative of fraud, and the need for specialized skills or the work of an expert;
- Establishing and evaluating the continued appropriateness of quantitative materiality levels (where appropriate), and considering qualitative materiality factors;
- Developing expectations for use when performing analytical procedures;
- Designing and performing further evidence-gathering procedures to reduce assurance engagement risk to an appropriate level; and
- Evaluating evidence, including the reasonableness of the responsible party's oral and written representations.

17. The practitioner uses professional judgment to determine the extent of the understanding required of the subject matter and other engagement circumstances. The practitioner considers whether the understanding is sufficient to assess the risks that the subject matter information may be materially misstated. The practitioner ordinarily has a lesser depth of understanding than the responsible party.

#### **Assessing the Appropriateness of the Subject Matter**

**18. The practitioner should assess the appropriateness of the subject matter.** An appropriate subject matter has the characteristics listed in paragraph 32 of the Framework. The practitioner also identifies those characteristics of the subject matter that are particularly relevant to the intended users, which are to be described in the assurance report. As indicated in paragraph 16 of the Framework, a practitioner does not accept an assurance engagement unless the practitioner's preliminary knowledge of the engagement circumstances indicates that the subject matter is appropriate. After accepting the engagement, however, if the practitioner concludes that the subject matter is not appropriate, the practitioner expresses a qualified or adverse conclusion or a disclaimer of conclusion. In some cases the practitioner considers withdrawing from the engagement.

#### **Assessing the Suitability of the Criteria**

**19. The practitioner should assess the suitability of the criteria to evaluate or measure the subject**

**matter.** Suitable criteria have the characteristics listed in paragraph 35 of the Framework. As indicated in paragraph 16 of the Framework, a practitioner does not accept an assurance engagement unless the practitioner's preliminary knowledge of the engagement circumstances indicates that the criteria to be used are suitable. After accepting the engagement, however, if the practitioner concludes that the criteria are not suitable, the practitioner expresses a qualified or adverse conclusion or a disclaimer of conclusion. In some cases the practitioner considers withdrawing from the engagement.

20. Paragraph 36 of the Framework indicates that criteria can either be established or specifically developed. Ordinarily, established criteria are suitable when they are relevant to the needs of the intended users. When established criteria exist for a subject matter, specific users may agree to other criteria for their specific purposes. For example, various frameworks can be used as established criteria for evaluating the effectiveness of internal control. Specific users may, however, develop a more detailed set of criteria that meet their specific needs in relation to, for example, prudential supervision. In such cases, the assurance report:

- (a) Notes, when it is relevant to the circumstances of the engagement, that the criteria are not embodied in laws or regulations, or issued by authorized or recognized bodies of experts that follow a transparent due process; and
- (b) States that it is only for the use of the specific users and for their purposes.

21. For some subject matters, it is likely that no established criteria exist. In those cases, criteria are specifically developed. The practitioner considers whether specifically developed criteria result in an assurance report that is misleading to the intended users. The practitioner attempts to have the intended users or the engaging party acknowledge that specifically developed criteria are suitable for the intended users' purposes. The practitioner considers how the absence of such an acknowledgement affects what is to be done to assess the suitability of the identified criteria, and the information provided about the criteria in the assurance report.

#### **Materiality and Assurance Engagement Risk**

**22. The practitioner should consider materiality and assurance**

#### **engagement risk when planning and performing an assurance engagement.**

23. The practitioner considers materiality when determining the nature, timing and extent of evidence-gathering procedures, and when evaluating whether the subject matter information is free of misstatement. Considering materiality requires the practitioner to understand and assess what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter information, the practitioner considers how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the practitioner's judgment.

**24. The practitioner should reduce assurance engagement risk to an acceptably low level in the circumstances of the engagement.** In a reasonable assurance engagement, the practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the practitioner's conclusion. The level of assurance engagement risk is higher in a limited assurance engagement than in a reasonable assurance engagement because of the different nature, timing or extent of evidence-gathering procedures. However, in a limited assurance engagement, the combination of the nature, timing, and extent of evidence-gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance as the basis for a negative form of expression. To be meaningful, the level of assurance obtained is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

25. Paragraph 48 of the Framework indicates that, in general, assurance engagement risk comprises inherent risk, control risk and detection risk. The degree to which the practitioner considers each of these components is affected by the engagement circumstances, in particular the nature of the subject matter and

whether a reasonable assurance or a limited assurance engagement is being performed.

#### Using the Work of an Expert

**26. When the work of an expert is used in the collection and evaluation of evidence, the practitioner and the expert should, on a combined basis, possess adequate skill and knowledge regarding the subject matter and the criteria for the practitioner to determine that sufficient appropriate evidence has been obtained.**

27. The subject matter and related criteria of some assurance engagements may include aspects requiring specialized knowledge and skills in the collection and evaluation of evidence. In these situations, the practitioner may decide to use the work of persons from other professional disciplines, referred to as experts, who have the required knowledge and skills. This SAE does not provide guidance with respect to using the work of an expert for engagements where there is joint responsibility and reporting by a practitioner and one or more experts.

28. Due care is a required professional quality for all individuals, including experts, involved in an assurance engagement. Persons involved in assurance engagements will have different responsibilities assigned to them. The extent of proficiency required in performing those engagements will vary with the nature of their responsibilities. While experts do not require the same proficiency as the practitioner in performing all aspects of an assurance engagement, the practitioner determines that the experts have a sufficient understanding of the SAEs to enable them to relate the work assigned to them to the engagement objective.

29. The practitioner adopts quality control procedures that address the responsibility of each person performing the assurance engagement, including the work of any experts who are not professional accountants, to ensure compliance with this SAE and other relevant SAEs in the context of their responsibilities.

**30. The practitioner should be involved in the engagement and understand the work for which an expert is used, to an extent that is sufficient to enable the practitioner to accept responsibility for the conclusion on the subject matter information.** The practitioner considers the extent to which it is reasonable to use the work of an expert in forming the practitioner's conclusion.

31. The practitioner is not expected to

possess the same specialized knowledge and skills as the expert. The practitioner has however, sufficient skill and knowledge to:

- (a) Define the objectives of the assigned work and how this work relates to the objective of the engagement;
- (b) Consider the reasonableness of the assumptions, methods and source data used by the expert; and
- (c) Consider the reasonableness of the expert's findings in relation to the engagement circumstances and the practitioner's conclusion.

**32. The practitioner should obtain sufficient appropriate evidence that the expert's work is adequate for the purposes of the assurance engagement.** In assessing the sufficiency and appropriateness of the evidence provided by the expert, the practitioner evaluates:

- (a) The professional competence, including experience, and objectivity of the expert;
- (b) The reasonableness of the assumptions, methods and source data used by the expert; and
- (c) The reasonableness and significance of the expert's findings in relation to the circumstances of the engagement and the practitioner's conclusion.

#### Obtaining Evidence

**33. The practitioner should obtain sufficient appropriate evidence on which to base the conclusion.**

Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability. The practitioner considers the relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an evidence-gathering procedure for which there is no alternative. The practitioner uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of evidence, and thus its sufficiency and appropriateness, to support the assurance report.

34. An assurance engagement rarely involves the authentication of documentation, nor is the practitioner trained as or expected to be an expert in such authentication. However, the practitioner considers the reliability of the information to be used as evidence, for example photocopies, facsimiles, filmed, digitized or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.

35. Sufficient appropriate evidence in a reasonable assurance engagement is obtained as part of an iterative, systematic engagement process involving:

- (a) Obtaining an understanding of the subject matter and other engagement circumstances which, depending on the subject matter, includes obtaining an understanding of internal control;
- (b) Based on that understanding, assessing the risks that the subject matter information may be materially misstated;
- (c) Responding to assessed risks, including developing overall responses, and determining the nature, timing and extent of further procedures;
- (d) Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures, including obtaining corroborating information from sources independent of the entity, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and
- (e) Evaluating the sufficiency and appropriateness of evidence.

36. "Reasonable assurance" is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- The use of selective testing.
- The inherent limitations of internal control.
- The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
- The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
- In some cases, the characteristics of the subject matter.

37. Both reasonable assurance and limited assurance engagements require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances. The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are, however, deliberately limited relative to a reasonable assurance engagement. For some subject matters, there may

be specific SAEs to provide guidance on procedures for gathering sufficient appropriate evidence for a limited assurance engagement. In the absence of a specific SAE, the procedures for gathering sufficient appropriate evidence will vary with the circumstances of the engagement, in particular: the subject matter, and the needs of the intended users and the engaging party, including relevant time and cost constraints. For both reasonable assurance and limited assurance engagements, if the practitioner becomes aware of a matter that leads the practitioner to question whether a material modification should be made to the subject matter information, the practitioner pursues the matter by performing other procedures sufficient to enable the practitioner to report.

### Representations by the Responsible Party

**38. The practitioner should obtain representations from the responsible party, as appropriate.** Written confirmation of oral representations reduces the possibility of misunderstandings between the practitioner and the responsible party. In particular, the practitioner requests from the responsible party a written representation that evaluates or measures the subject matter against the identified criteria, whether or not it is to be made available as an assertion to the intended users. Having no written representation may result in a qualified conclusion or a disclaimer of conclusion on the basis of a limitation on the scope of the engagement. The practitioner may also include a restriction on the use of the assurance report.

39. During an assurance engagement, the responsible party may make representations to the practitioner, either unsolicited or in response to specific inquiries. When such representations relate to matters that are material to the subject matter's evaluation or measurement, the practitioner:

- (a) Evaluates their reasonableness and consistency with other evidence obtained, including other representations;
- (b) Considers whether those making the representations can be expected to be well informed on the particular matters; and
- (c) Obtains corroborative evidence in the case of a reasonable assurance engagement. The practitioner may also seek corroborative evidence in the case of a limited assurance engagement.

40. Representations by the responsible

party cannot replace other evidence the practitioner could reasonably expect to be available. An inability to obtain sufficient appropriate evidence regarding a matter that has, or may have, a material effect on the evaluation or measurement of the subject matter, when such evidence would ordinarily be available, constitutes a limitation on the scope of the engagement, even if a representation from the responsible party has been received on the matter.

### Considering Subsequent Events

**41. The practitioner should consider the effect on the subject matter information and on the assurance report of events up to the date of the assurance report.**

The extent of consideration of subsequent events depends on the potential for such events to affect the subject matter information and to affect the appropriateness of the practitioner's conclusion. Consideration of subsequent events in some assurance engagements may not be relevant because of the nature of the subject matter. For example, when the engagement requires a conclusion about the accuracy of a statistical return at a point in time, events occurring between that point in time and the date of the assurance report, may not affect the conclusion, or require disclosure in the return or the assurance report.

### Documentation

**42. The practitioner should document matters that are significant in providing evidence that supports the assurance report and that the engagement was performed in accordance with SAEs.**

43. Documentation includes a record of the practitioner's reasoning on all significant matters that require the exercise of judgment, and related conclusions. The existence of difficult questions of principle or judgment, calls for the documentation to include the relevant facts that were known by the practitioner at the time the conclusion was reached.

44. It is neither necessary nor practical to document every matter the practitioner considers. In applying professional judgment to assessing the extent of documentation to be prepared and retained, the practitioner may consider what is necessary to provide an understanding of the work performed and the basis of the principal decisions taken (but not the detailed aspects of the engagement) to another practitioner who has no previous

experience with the engagement. That other practitioner may only be able to obtain an understanding of detailed aspects of the engagement by discussing them with the practitioner who prepared the documentation.

### Preparing the Assurance Report

**45. The practitioner should conclude whether sufficient appropriate evidence has been obtained to support the conclusion expressed in the assurance report.** In developing the conclusion, the practitioner considers all relevant evidence obtained, regardless of whether it appears to corroborate or to contradict the subject matter information.

**46. The assurance report should be in writing and should contain a clear expression of the practitioner's conclusion about the subject matter information.**

47. Oral and other forms of expressing conclusions can be misunderstood without the support of a written report. For this reason, the practitioner does not report orally or by use of symbols without also providing a definitive written assurance report that is readily available whenever the oral report is provided or the symbol is used. For example, a symbol could be hyperlinked to a written assurance report on the Internet.

48. This SAE does not require a standardized format for reporting on all assurance engagements. Instead it identifies in paragraph 49 the basic elements the assurance report is to include. Assurance reports are tailored to the specific engagement circumstances. The practitioner chooses a "short form" or "long form" style of reporting to facilitate effective communication to the intended users. "Short-form" reports ordinarily include only the basic elements. "Long-form" reports often describe in detail the terms of the engagement, the criteria being used, findings relating to particular aspects of the engagement and, in some cases, recommendations, as well as the basic elements. Any findings and recommendations are clearly separated from the practitioner's conclusion on the subject matter information, and the wording used in presenting them makes it clear they are not intended to affect the practitioner's conclusion. The practitioner may use headings, paragraph numbers, typographical devices, for example the bolding of text, and other mechanisms to enhance the clarity and readability of the assurance report.

## Assurance Report Content

### 49. The assurance report should include the following basic elements:

**(a) A title that clearly indicates the report is an independent assurance report:**<sup>4</sup> an appropriate title helps to identify the nature of the assurance report, and to distinguish it from reports issued by others, such as those who do not have to comply with the same ethical requirements as the practitioner.

**(b) An addressee:** an addressee identifies the party or parties to whom the assurance report is directed. Whenever practical, the assurance report is addressed to all the intended users, but in some cases there may be other intended users.

**(c) An identification and description of the subject matter information and, when appropriate, the subject matter:** this includes for example:

- The point in time or period of time to which the evaluation or measurement of the subject matter relates;
- Where applicable, the name of the entity or component of the entity to which the subject matter relates; and
- An explanation of those characteristics of the subject matter or the subject matter information of which the intended users should be aware, and how such characteristics may influence the precision of the evaluation or measurement of the subject matter against the identified criteria, or the persuasiveness of available evidence. For example:
  - ▶ The degree to which the subject matter information is qualitative versus quantitative, objective versus subjective, or historical versus prospective.
  - ▶ Changes in the subject matter or other engagement circumstances that affect the comparability of the subject matter information from one period to the next.

When the practitioner's conclusion is worded in terms of the responsible party's assertion, that assertion is appended to the assurance report, reproduced in the assurance report or referenced therein to a source that is available to the intended users.

**(d) Identification of the criteria:** the assurance report identifies the criteria against which the subject matter was evaluated or measured so the intended users can understand the basis for the practitioner's conclusion. The assurance report may include the criteria, or refer to them if they are contained in an assertion prepared by the responsible party that is available to the intended users or if they are otherwise available from a readily accessible source. The practitioner considers whether it is relevant to the circumstances, to disclose:

- The source of the criteria, and whether or not the criteria are embodied in laws or regulations, or issued by authorized or recognized bodies of experts that follow a transparent due process, that is, whether they are established criteria in the context of the subject matter (and if they are not, a description of why they are considered suitable);
- Measurement methods used when the criteria allow for choice between a number of methods;
- Any significant interpretations made in applying the criteria in the engagement circumstances; and
- Whether there have been any changes in the measurement methods used.

**(e) Where appropriate, a description of any significant, inherent limitation associated with the evaluation or measurement of the subject matter against the criteria:** while in some cases, inherent limitations can be expected to be well understood by readers of an assurance report, in other cases it may be appropriate to make explicit reference in the assurance report. For example, in an assurance report related to the effectiveness of internal control, it may be appropriate to note that

the historic evaluation of effectiveness is not relevant to future periods due to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

**(f) When the criteria used to evaluate or measure the subject matter are available only to specific intended users, or are relevant only to a specific purpose, a statement restricting the use of the assurance report to those intended users or that purpose:** in addition, whenever the assurance report is intended only for specific intended users or a specific purpose, the practitioner considers stating this fact in the assurance report<sup>5</sup>. This provides a caution to readers that the assurance report is restricted to specific users or for specific purposes.

**(g) A statement to identify the responsible party and to describe the responsible party's and the practitioner's responsibilities:** this informs the intended users that the responsible party is responsible for the subject matter in the case of a direct reporting engagement, or the subject matter information in the case of an assertion-based engagement<sup>6</sup>, and that the practitioner's role is to independently express a conclusion about the subject matter information.

**(h) A statement that the engagement was performed in accordance with SAEs:** where there is a subject matter specific SAE, that SAE may require that the assurance report refer specifically to it.

**(i) A summary of the work performed:** the summary will help the intended users understand the nature of the assurance conveyed by the assurance report. SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements"<sup>7</sup> and Proposed Revised SRE 2400, "Engagements to Review Financial Statements"<sup>8</sup> provide a guide to the appropriate type of summary. Where no specific SAE provides guidance on evidence-gathering

<sup>4</sup> See footnote 2.

<sup>5</sup> While an assurance report may be restricted whenever it is intended only for specified intended users or for a specific purpose, the absence of a restriction regarding a particular reader or purpose does not itself indicate that a legal responsibility is owed by the practitioner in relation to that reader or for that purpose. Whether a legal responsibility is owed will depend on the legal circumstances of each case and the relevant jurisdiction.

<sup>6</sup> Refer to paragraph 9 of the Framework for an explanation of the distinction between a direct engagement and an assertion-based engagement.

<sup>7</sup> SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

<sup>8</sup> The Exposure Draft of proposed Revised SRE 2400, "Engagements to Review Financial Statements" has been published in the June, 2009 issue of the Journal.

procedures for a particular subject matter, the summary might include a more detailed description of the work performed. Because in a limited assurance engagement an appreciation of the nature, timing, and extent of evidence-gathering procedures performed is essential to understanding the assurance conveyed by a conclusion expressed in the negative form, the summary of the work performed:

- (i) Is ordinarily more detailed than for a reasonable assurance engagement and identifies the limitations on the nature, timing, and extent of evidence-gathering procedures. It may be appropriate to indicate procedures that were not performed that would ordinarily be performed in a reasonable assurance engagement; and
- (ii) States that the evidence-gathering procedures are more limited than for a reasonable assurance engagement, and that therefore less assurance is obtained than in a reasonable assurance engagement.

- (j) The practitioner's conclusion:** where the subject matter information is made up of a number of aspects, separate conclusions may be provided on each aspect. While not all such conclusions need to relate to the same level of evidence-gathering procedures, each conclusion is expressed in the form that is appropriate to either a reasonable-assurance or a limited assurance engagement.

**Where appropriate, the conclusion should inform the intended users of the context in which the practitioner's conclusion is to be read:** the practitioner's conclusion may, for example, include wording such as: "This conclusion has been formed on the basis of, and is subject to the inherent limitations outlined elsewhere in this independent assurance report." This would be appropriate, for example, when the report includes an explanation of particular characteristics of the subject matter of which the intended users should be aware.

**In a reasonable assurance engagement, the conclusion**

**should be expressed in the positive form:** for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*" or "In our opinion *the responsible party's* assertion that internal control is effective, in all material respects, based on *XYZ criteria*, is fairly stated."

**In a limited assurance engagement, the conclusion should be expressed in the negative form:** for example: "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on *XYZ criteria*" or "Based on our work described in this report, nothing has come to our attention that causes us to believe that *the responsible party's* assertion that internal control is effective, in all material respects, based on *XYZ criteria*, is not fairly stated".

**Where the practitioner expresses a conclusion that is other than unqualified, the assurance report should contain a clear description of all the reasons:** (also see paragraphs 51-53).

- (k) Practitioner's Signature:** the report should be signed by the practitioner in his personal name. Where the firm is appointed, the report should be signed in the personal name of the engagement partner and in the name of the firm. The partner/proprietor signing the assurance report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also need to include the registration number of the firm, wherever applicable, as allotted by ICAI, in the assurance reports signed by them.

- (l) The assurance report date:** this informs the intended users that the practitioner has considered the effect on the subject matter information and on the assurance report of events that occurred up to that date.

- (m) The place of signature – the report should name specific location, which is ordinarily the city where the report is signed.**

50. The practitioner may expand the assurance report to include other

information and explanations that are not intended to affect the practitioner's conclusion. Examples include: details of the qualifications and experience of the practitioner and others involved with the engagement, disclosure of materiality levels, findings relating to particular aspects of the engagement, and recommendations. Whether to include any such information depends on its significance to the needs of the intended users. Additional information is clearly separated from the practitioner's conclusion and worded in such a manner so as not to affect that conclusion.

#### **Qualified Conclusions, Adverse Conclusions and Disclaimers of Conclusion**

**51. The practitioner should not express an unqualified conclusion when the following circumstances exist and, in the practitioner's judgment, the effect of the matter is or may be material:**

- (a) There is a limitation on the scope of the practitioner's work, that is, circumstances prevent, or the responsible party or the engaging party imposes a restriction that prevents, the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level. The practitioner should express a qualified conclusion or a disclaimer of conclusion;**

- (b) In those cases where:**

- (i) The practitioner's conclusion is worded in terms of the responsible party's assertion, and that assertion is not fairly stated, in all material respects; or**

- (ii) The practitioner's conclusion is worded directly in terms of the subject matter and the criteria, and the subject matter information is materially misstated<sup>9</sup>, the practitioner should express a qualified or adverse conclusion; or**

- (c) When it is discovered, after the engagement has been accepted, that the criteria are unsuitable or the subject matter is not appropriate for an assurance engagement. The practitioner should express:**

- (i) A qualified conclusion or adverse conclusion when**

<sup>9</sup> In those direct reporting engagements where the subject matter information is presented only in the practitioner's conclusion, and the practitioner concludes that the subject matter does not, in all material respects, conform with the criteria, for example: "In our opinion, except for [...], internal control is effective, in all material respects, based on *XYZ criteria*", such a conclusion would also be considered to be qualified (or adverse as appropriate).

the unsuitable criteria or inappropriate subject matter is likely to mislead the intended users; or  
(ii) A qualified conclusion or a disclaimer of conclusion in other cases.

**52. The practitioner should express a qualified conclusion when the effect of a matter is not so material or pervasive as to require an adverse conclusion or a disclaimer of conclusion. A qualified conclusion is expressed as being "except for" the effects of the matter to which the qualification relates.**

53. In those cases where the practitioner's unqualified conclusion would be worded in terms of the responsible party's assertion, and that assertion has identified and properly described that the subject matter information is materially misstated, the practitioner either:

- Expresses a qualified or adverse conclusion worded directly in terms of the subject matter and the criteria; or
- If specifically required by the terms of the engagement to word the conclusion in terms of the responsible party's assertion, expresses an unqualified conclusion but emphasizes the matter by specifically referring to it in the assurance report.

#### Other Reporting Responsibilities

**54. The practitioner should consider other reporting responsibilities, including the appropriateness of communicating relevant matters of governance interest arising from the assurance engagement with those charged with governance.**

55. In this SAE, "governance" describes the role of persons entrusted with the supervision, control and direction of a responsible party<sup>10</sup>. Those charged with governance ordinarily are accountable for ensuring that an entity achieves its objectives and for reporting to interested parties. If the engaging party is different from the responsible party it may not be appropriate to communicate directly with the responsible party or those charged with governance over the responsible party.

56. In this SAE, "relevant matters of governance interest" are those that arise from the assurance engagement and, in the practitioner's opinion, are both important and relevant to those charged with governance. Relevant matters of governance interest include only those matters that have come to the attention of the practitioner while performing the assurance engagement. If the terms of the engagement do not specifically require it, the practitioner is not required to design procedures for the specific purpose of identifying matters of governance interest.

#### Effective Date

57. This SAE is effective for assurance engagements where the assurance report is dated on or after - - - - -

#### Modifications *vis-a-vis* ISAE 3000, "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information"

##### Addition

Paragraph 49 (l) of ISAE 3000 requires to mention the name of the specific location, which ordinarily is the city where the practitioner maintains the office that has responsibility for the engagement. Since in India, Standard on Auditing (SA) 700 requires to mention the place of the signature, i.e., the name of specific location, which is ordinarily the city where the report is signed, the requirement of mentioning the practitioner's office address has been replaced with the place of signature.

<sup>10</sup> In many countries, principles of governance have been developed as a point of reference for establishing good governance behaviour. Such principles often focus on publicly traded companies; they may however, also serve to improve governance in other forms of entities. There is no single model of good governance. Governance structures and practices vary from country to country.

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# CROSS

**WORD** | 045

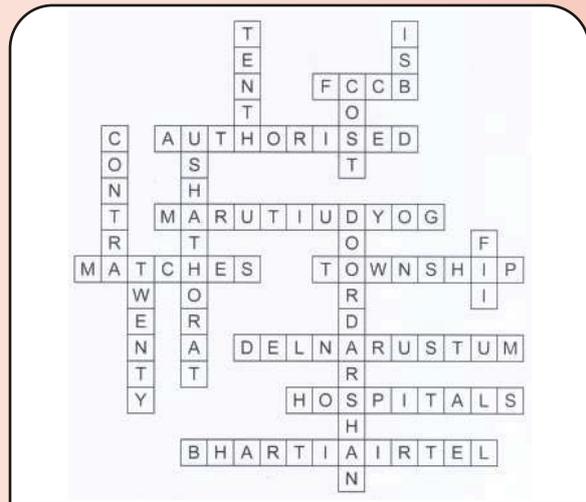
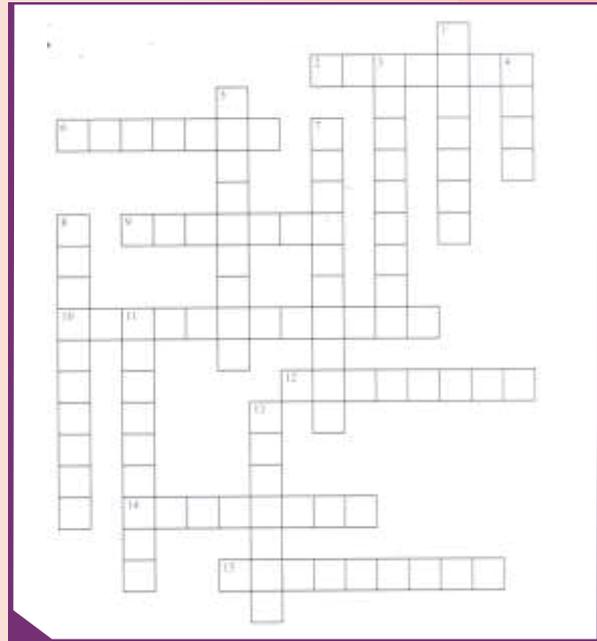
**ACROSS**

2. The denominator used in calculating a turnover ratio should be the \_\_\_\_\_ amount of the balance sheet account during the period of the numerator. (7)
6. GCC Conference was held at \_\_\_\_\_. (7)
9. Depreciation is a \_\_\_\_\_ expense.
10. The largest companies in the United States are not sole proprietorships; rather, they are \_\_\_\_\_. (12)
12. One step in determining the net present value of a project is to discount the future cash flows by the \_\_\_\_\_ rate of return. (8)
14. The \_\_\_\_\_ rate of return uses discounted cash flows. (8)
15. One of the research project completed under the ICAI-ARF is on Business \_\_\_\_\_. (9)

**DOWN**

1. This method of evaluating projects uses cash flows that are NOT discounted. (7)
3. A new portal initiated for redressal of member's and students grievances. (9)
4. One of the currency in which trading in Currency Derivates has recently been started. (4)
5. Elected by stockholders to establish the policies of a corporation. (9)
7. The maximum number of shares that a company can issue is the \_\_\_\_\_ capital. (10)
8. A common-size income statement expresses all amounts as a \_\_\_\_\_ of net sales. (10)
11. This type of entry occurs on the first day of the accounting period and is often the amount of an accrual-type adjusting entry made on the previous day. (9)
13. The accounting rate of return uses the accounting amounts under the \_\_\_\_\_ basis of accounting. (7)

Note:  
Members can claim one hour CPE Credit – Unstructured Learning through self-declaration for attempting above Crossword.



**SOLUTION Crossword** 044



**Please**

**1**

In a small firm, employing about a dozen low salaried staff, the usual practice for the salary disbursement was to pay in cash across the counter. After one such disbursement, while tallying the cash, the cashier came to know that he has, by mistake, paid Rs.500 more to some one and as such there was a shortfall of 500 Rupees. He had a faint idea that probably he might have paid the excess amount to one Mr. Pravin. So, when the next month's disbursement was being done, he deliberately paid Rs.500 Rupees less to Mr. Pravin. Immediately Mr. Pravin protested and demanded 500 Rupees. The cashier retorted "Mr. Pravin, when last month you were paid Rs.500 more by mistake, why did you not tell any thing about it?" Mr. Pravin replied "My friend, I can condone one mistake, but how can I condone the second mistake? So please pay me the full amount."