The following is the text of the Guidance Note on Audit of Property, Plant and Equipment (PPE) issued by the Auditing and Assurance Standards Board (AASB) of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" issued by the Institute.

1. Paragraph 26 of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" states that “Guidance Notes are issued to assist professional accountants in implementing the Engagement Standards and the Standards on Quality Control issued by the AASB under the authority of the Council. Guidance Notes are also issued to provide guidance on other generic or industry specific audit issues, not necessarily arising out of a Standard. Professional accountants should be aware of and consider Guidance Notes applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Guidance Note should be prepared to justify the appropriateness and completeness of the alternate procedures adopted by him to deal with the objectives and basic principles set out in the Guidance Note."

2. This Guidance Note does not supersede the Institute's publications which provide guidance on audit of Property, Plant and Equipment (PPE) with special reference to certain statutory requirements, e.g., the guidance contained in the Statement on the Companies (Auditor's Report) Order, 2003.

3. The Guidance Note has been prepared considering the relevant Revised Accounting Standard 16, “Property, Plant & Equipment” (corresponding to IAS 16) which is being issued by the Institute pursuant to the decision to converge with the International Financial Reporting Standards (IFRS) in respect of accounting periods commencing on or after April 1, 2011 and the existing Accounting standards, AS 10 “Accounting for Fixed assets” and AS 6 “Depreciation Accounting” which are applicable to the entities who are not required to comply with the relevant Revised AS. Both the categories of the Accounting Standards are collectively referred to as the “relevant applicable AS”.

4. The Guidance Note does not apply to audit of Investment Property and Intangible Assets.

5. In the event of a possible or perceived contradiction between the Guidance Note and a Standard on Auditing (SA) issued by the Institute, the Standard shall prevail.
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Introduction

6. The term *Property, plant and equipment in respect of those entities which are required to comply with the relevant Revised AS* refers to such tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

In respect of such entities which need to apply AS 10 and AS 6, the term "Property, Plant and Equipment" comprises assets held for the purpose of providing or producing goods or services and which are not meant for sale in the normal course of business. Judgement is required to be exercised in recognizing what constitutes an item of property, plant and equipment having regard to an entity's specific circumstances. For example, major spare parts, servicing equipment, and stand-by equipment, which an entity expects to use during more than one period, can be recognised as PPE as per the relevant Revised AS.

7. An asset can be classified as a PPE or otherwise, depending upon the use to which it is put or intended to be put. For example, assets which are classified as PPE in one type of business may be considered as current assets in another. Similarly, the same asset may be classified differently in an entity at different points of time. The recognition of Property, Plant and Equipment should be done as per the principles laid down in the "relevant applicable AS".

8. PPE normally constitute a significant portion of the total assets, particularly in a manufacturing entity. Audit of PPE, therefore, assumes considerable importance.

9. The following features of PPE have an impact on the related audit procedures:

(a) By their very nature, PPE are turned over much slower than current assets which are held for sale. Normally, PPE are carried over from year to year.

(b) The average unit of PPE is normally of a relatively larger rupee value.

(c) Since PPE are high value items, their acquisition is normally more closely controlled. The control aspect assumes special significance where PPE are self-constructed.

(d) PPE are generally accounted for once unlike other assets like stock, because of which any error would affect the financial statements permanently or at least for a significant period of time.

(e) In an inflationary situation, where cost model is adopted, normally, the book values of PPE are considerably lower than their replacement values.
Risks Associated with Property, Plant and Equipment

Inherent Risks

10. The auditor needs to obtain an understanding of the client and its environment to consider inherent risk, including fraud risks, related to property, plant, and equipment. This includes:

(a) Obtaining an understanding of the internal control over property, plant, and equipment. For example, preparation of and review of capital budgets, etc.

(b) Assessing the risks of material misstatement and designing tests of controls and substantive procedures that cover the following aspects:

   (i) Substantiate the existence of property, plant, and equipment. PPE may include assets that should have been derecognised following sale, other transfer of rights or abandonment. Auditor should verify title deeds, agreements or other ownership documents.

   (ii) Establish the completeness of recorded property, plant, and equipment. Expenditure that should have been recognised as property, plant and equipment but has not been so recognized, including capitalised finance costs, failure to account for assets held under finance leases or hire purchase agreements.

   (iii) Verify the cutoff of transactions affecting property, plant, and equipment.

   (iv) Determine that the client has the rights to the recorded property, plant, and equipment.

   (v) Establish the proper valuation or allocation of property, plant, and equipment and the accuracy of transactions affecting PPE.

   (vi) Determine the correctness and appropriateness of classification of property, plant and equipment. For example, incorrect split between land and buildings or between long term and short term leaseholds. Classification may have a significant impact on the application of the accounting policies. As per relevant Accounting Standard, the entities have to follow the component approach, as may be applicable.

   (vii) Depreciation value - Depreciation may have been incorrectly calculated on account of factors such as:

       • mechanical error; or
       • incorrect application of accounting policy; or
       • inappropriate assessment of remaining useful life; or
       • inappropriate assessment of residual value; or
       • incorrect classification of the asset.

   (viii) Carrying cost - Where a valuation model is followed - carrying amount may not
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reflect fair value due to factors including:

- failure to update valuations for current circumstances; or
- failure to brief valuers correctly, use of invalid assumptions or data, etc., or
- valuations not performed by competent personnel.

(ix) Existence / valuation - tangible assets acquired in a business combination may not have been initially recognised at their fair value at that date.

(x) Value of impairment - failure to recognise impairment or reversal of impairment.

(xi) Determine that the presentation and disclosure of property, plant, and equipment are appropriate.

Fraud Risks and Errors

11. Some of the potential misstatements in PPE on account of frauds and errors include:

(a) Purchase of an asset at an inflated price especially from a related party.

(b) Wrong write-off of the asset as scrap, obsolescence, missing, donated, or destroyed.

(c) Expenditures for repairs and maintenance recorded as PPE or vice versa.

(d) Capitalisation of expenditure which are not normally attributable to the cost of the PPE.

(e) Recording of an asset purchased, which in effect has not actually been received by the entity at all.

(f) Removal of an asset paid for by the entity or use of an asset of the entity for the benefit of a person other than the entity.

12. Such errors and frauds could occur because of weak internal controls in the entity including:

(a) Inadequate involvement of management in overseeing employees with access to cash or other assets susceptible to misappropriation.

(b) PPE which are small in size, marketable, or lacking observable identification of ownership.

(c) Lack of complete and timely verification and reconciliations of assets.

(d) Inadequate physical safeguards over PPE.

(e) The misuse of the entity’s assets by an employee.

(f) Using an entity’s assets for personal use (for example, using the entity’s assets as collateral for a personal loan or a loan to a related party).

(g) The asset is intentionally sold below fair market value.

13. The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatements. These would include:
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(a) Inquiries of management and others within the entity to identify the risks. For example, control procedures, entity's objectives and strategies, incentive policies, etc.

(b) Analytical procedures, for example, Ratios, etc.

(c) Observation and inspection of the entity's premises and plant facilities.

Internal Controls

14. An auditor should review the system of internal controls relating to PPE, particularly the following:

(a) Control over expenditure incurred on PPE acquired or self-constructed- An effective method of exercising this control is capital budgeting, which, apart from ensuring proper authorisation of the expenditure incurred, also shows, in general, how effectively such expenditure is being controlled through periodical comparisons of actuals with budgeted figures. It also ensures that amounts expended do not exceed the amounts authorized, and controls allocation of expenditure between capital and revenue in the case of self constructed assets.

(b) Accountability and utilisation controls - Accountability over each PPE (or each class or component of PPE (in the case of companies following the relevant Revised AS)) is established, among other things, by maintaining appropriate records. This facilitates control over custodianship of such assets, for example, physical verification by the management or establishment of procedures relating to disposal of PPE. On the other hand, utilisation controls ensure that the individual PPE have been properly used for meeting the objectives of the entity.

(c) Information controls - These controls ensure that reliable information is available for calculating and allocating depreciation, recording disposals or retirements, preparing tax returns, establishing the amount of insurance coverage, filing insurance claims, controlling repairs and maintenance charges or expenses incurred for inspection to assess the condition of the asset, replacement cost of specific parts, useful life of assets or specific parts, eg, specified number of hours of use, etc.

(d) Safeguarding of assets - These controls ensure that the assets owned by the entity are safeguarded and any loss on damage / destruction of such assets are made good, through for example, insurance of assets, warranties, etc. The entity may have a process by which responsibility to safeguard the assets could be identified to specific personnel.

Substantive Procedures

15. Verification of PPE consists of examination of related records and physical verification. The auditor should, normally, verify the records with reference to the documentary evidence and by evaluation of internal controls. Physical verification of PPE is primarily the responsibility of the management.

16. The auditor must also consider the appropriateness of the accounting policies, including
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policies for determining which costs are capitalised, whether a cost or valuation model is
followed and depreciation (including assessment of residual values) appropriately calculated.

17. As per the relevant Revised AS, the auditor should ensure that the entity has capitalised
the assets as per the component approach, whereby a component or part of an asset which is
significant in value compared to the total value of the asset or the useful life of which is
different from that of the asset, has to be capitalised separately.

Verification of Records

Opening Balances

18. The opening balances of the existing PPE should be verified from records such as the
schedule of PPE, ledger or register balances. In the case of initial engagements, as per SA 510
(Revised), "Initial Audit Engagements – Opening Balances", for the purpose of ascertaining the
accuracy of the opening balance of PPE, some audit evidence may be obtained by examining the
accounting records and other information underlying the opening balances.

19. The auditor would also need to obtain summary of changes to PPE and reconcile the
same to the ledgers.

Capital Work in Progress

20. The auditor must verify records to ensure that the assets under construction or pending
installation and not yet ready for intended use are classified as work in progress.

21. Capital work in progress should be verified with reference to the underlying contractor
bills, work orders, certification of work performed by independent persons, comparison of the
progress and the costs incurred up-to-date with the budgets, capital asset management policy
and plan, pending commitments, etc.

22. It must be ensured that an appropriate system is in place to capture all directly
identifiable costs, which can be capitalized, to be so accumulated to the capital work in
progress (WIP) whilst expenses which are not eligible for being capitalized are identified and
charged to revenue in the normal course. The auditor should reconcile the movement of
capital work in progress from opening to closing, specifically verifying additions during the
year, capital assets completed during the years and impairment of any opening capital work in
progress items. The closing work in progress value should be bifurcated asset class wise or
project wise so that reconciliation of the capital WIP is made easier and more logical. The
Capital work in progress should be reviewed with respect to the intention and ability of the
management to carry forward and bring the asset to its state of intended use. The auditor
should also specifically verify the date on which the assets are moved from the capital work in
progress account to the fixed assets (the date on which the asset is ready for intended use),
so that the depreciation on fixed assets may be computed correctly.
Additions to PPE

23. Acquisition of new PPE and improvements to the existing ones should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds and applicable customs or excise documents. Due care needs to be taken when the purchase is from a related party. The auditor may employ procedures such as possible comparative prices prevalent in a ready market, evaluation, justification and approvals for the purchase.

24. Self-constructed PPE and improvements thereto should be verified with reference to the supporting documents such as contractors' bills, work-order records, installation certification, completion certificates and independent confirmation of the work performed.

25. The auditor should make appropriate enquiries and examine lease contracts to provide evidence that PPE acquired under finance leases or hire purchase agreements have been properly capitalized.

26. In respect of the additions to PPE during the year, the supporting documentation and information for the date on which the asset was put to use / was ready to use is required to be verified.

27. Assets acquired in exchange for a non monetary asset(s) should be verified with reference to the supporting documents for the commercial substance of the transaction (cash flows from the assets acquired against those given up) and the value of the asset given up.

28. The auditor should review expense accounts (e.g., Repairs and Renewals) to ascertain that new capital assets and improvements have not been included therein.

Ownership of PPE

29. The ownership of assets, like land and buildings, may be verified by examining the title deeds. In case the title deeds are held by other persons, such as solicitors or bankers, confirmation should be, at least where significant, obtained directly by the auditors through a request signed by the client.

30. The auditor would also need to perform procedures to obtain corroborating evidence that the client actually possesses the rights associated with the assets under consideration. For example, the fact that the cash flows or economic benefits associated with it are actually accruing to the client.

Impairment of PPE

31. The auditor needs to consider whether there are circumstances as per AS that indicate a possible impairment of property, plant and equipment and if such circumstances exist, how the same have been dealt with by the entity. Decline in the market value of assets, changes in technological, legal or economic environment in which the entity operates, evidence of physical damage of assets, are some indications of impairment.

Deletions from PPE

32. Where PPE have been written-off or fully depreciated in the year of acquisition/construction, the auditor should examine whether these were recorded in the PPE
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register before being written-off or depreciated.

33. In respect of PPE retired, i.e., destroyed, held for sale, scrapped or sold, the auditor needs to examine the following aspects, *inter alia*:

(a) whether the retirements have been properly authorised and appropriate procedures for invitation of quotations have been followed wherever applicable;

(b) whether the assets and depreciation accounts have been properly adjusted;

(c) whether the sale proceeds, if any, have been fully accounted for; and

(d) whether the resulting gains or losses, if material, have been properly adjusted and disclosed in the Profit and Loss Account.

34. It is possible that certain assets destroyed, scrapped or sold during the year have not been recorded. The auditor may use the following procedures to ascertain such omissions:

(a) Review work orders/physical verification reports to trace any indicated retirements.

(b) Examine major additions to ascertain whether they represent additional facilities or replacement of old assets, which may have been retired.

(c) Make enquiries of key management and supervisory personnel.

(d) Obtain a certificate from a senior official and/or departmental managers that all assets scrapped, destroyed or sold have been recorded in the books.

35. The auditor would also need to review the board minutes and other correspondence for indications of significant asset acquisitions, disposals or retirements.

36. Where there has been a change of use, the auditor would need to consider whether this gives rise to a need to change classification of the asset (eg, to inventory), assets held for sale, investment property, etc.

**Physical Verification**

37. It is the responsibility of the management to carry out physical verification of PPE at appropriate intervals in order to ensure that they are in existence. However, the auditor should satisfy himself that such verification was done by observing the verification being conducted by the management wherever possible and by examining the written instructions issued to the staff by the management and the relevant working papers. The auditor should also satisfy himself that the persons conducting the verification, whether the employees of the entity or outside experts have the necessary competence.

38. The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. SA 501, "Audit Evidence – Specific Considerations for Selected Items" contain principles related to the auditor’s responsibilities and procedures in respect of attendance at physical inventory counting undertaken by the
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management. It would not be realistic to expect the management to suspend manufacturing operations for conducting a physical verification of the PPE, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land. Where the PPE can be moved and where verification of all assets cannot be conducted at the same time, they should be marked with distinctive numbers.

39. The auditor should apply appropriate emphasis on the verification of assets by the management of the assets which are outside the premises of the company, with third parties. This may be by way of a process of physical verification by the management or by way of obtaining confirmation from the third party holding the asset, depending on the management’s risk assessment of such assets and the materiality of such assets.

40. The auditor should examine whether the frequency of verification was reasonable in the circumstances of each case. Where the assets are few and can be easily verified, an annual verification may be considered as reasonable. However, where the assets are numerous and difficult to verify, verification, say, once every three years by rotation - so that all assets are verified at least once in every three years – may be sufficient.

41. The auditor should test check the records of PPE with the physical verification reports. He should examine whether discrepancies noticed on physical verification have been properly dealt with. In this regard the auditor should use his judgement as to whether having regard to the circumstances, the discrepancy is material enough to warrant an adjustment in the accounts and/or modification in the internal control system.

Recognition

42. The auditor should ensure that the cost of an item of property, plant and equipment is recognised as an asset only when the costs have been reliably measured and it has been ascertained by the management that future economic benefits will flow to the entity.

43. The auditor should also verify that the entity has recognised a fixed asset in accordance with the generally accepted accounting principles applicable to the entity.

44. Capital work in progress: The auditor should verify that PPE under construction are recognized as capital work in progress until such time they are ready for intended use. The auditor should also verify that only those costs that could be capitalised are included under work in progress.

45. Component approach: As per the relevant revised AS, in the component approach of accounting for the PPE, the auditor should verify that the relevant PPE are capitalised as components where the useful life of the components significantly vary from the useful life of
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the entire asset (e.g., Cost of relining a furnace, aircraft seats which require replacement at regular intervals and, thus, have a varying useful life from the rest of the furnace or aircraft, respectively). Each major part of the item of PPE with a cost that is significant in relation to the total cost of the item is depreciated separately.

However, where the entity has originally not recognised a component separately, but subsequently replaces the part or a component, the auditor needs to verify that such replacements are capitalised only if the capacity or useful life of the asset increased, or quality of output improved or operating costs were reduced over and above that which was originally intended or estimated for the asset. The replaced part is derecognised.

Valuation

Carrying Cost of PPE

46. The auditor should satisfy himself that the PPE have been valued in the financial statements according to the generally accepted bases of accounting and as per the applicable reporting framework which are determined by law, professional pronouncements of the Institute and the prevailing industry practices.

47. After initial recognition of the asset, in the case of subsequent measurement, the auditor should verify that the value of the asset is as per the model chosen by the entity as cost or revaluation model.

48. The auditor should also satisfy himself that the method by which the fair value has been determined is reasonable for the asset under consideration. For example, the market value method, income approach or the depreciated cost approach.

49. The auditor should also satisfy himself that the value has been determined with the help of a person competent to value the assets under consideration.

50. As per the relevant Revised AS, the auditor should verify that costs of major inspections, cost of spares used in connection with an asset and expected to be used for more than one period are added to cost of asset and derecognized earlier cost as per generally accepted accounting principles.

51. The auditor should consider whether the entity has reviewed the carrying value of its assets and how it determines the recoverable amount of the asset.

52. As per the relevant Revised AS, where several assets have been purchased for a consolidated price, the auditor should examine the method by which the consideration has been apportioned to the various assets. In case this has been done on the basis of an expert valuation, he should examine whether the same appears reasonable and based on adequate facts.

53. Where an entity owns assets jointly with others (otherwise than as a partner in a firm) the auditor should examine the relevant documents such as title deeds, agreements, etc., in order to ascertain the extent of the entity’s share in such assets. The assets are used to obtain benefits for the entity and /or the entity recognizes its share of the assets. The auditor needs
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to verify the underlying agreements and the benefits which the entity receives or expects to receive as per generally accepted accounting principles.

54. As per the relevant Revised AS, where the entities have obligations to dismantle, remove and restore items of property, plant and equipment, the cost of an item of plant and equipment have to include such costs. The auditor should examine the method and process of identification, estimation and treatment of such costs based on the model in which the asset is measured in accordance with the generally accepted accounting principles.

55. The auditor must ensure that the cost of self constructed assets include all the items of costs which are to be capitalized including specific direct expenses related to the asset and appropriate borrowing costs.

56. As per the relevant Revised AS, the auditor should ensure that the cost of self constructed assets do not include cost of abnormal wastage of material labour or other resources.

57. As per the relevant Revised AS, the auditor should also verify the payment towards the assets beyond the normal credit terms to confirm the cost which can be capitalized.

PPE Acquired on/or as Government Grants

58. When the entity acquires land or other fixed assets as government grants at concessional rates, then the entity has to account for such assets at the acquisition cost. In case the asset is acquired free of cost, it should be accounted at nominal value.

59. The grant can be shown as a deduction from the gross value of assets or the asset can be shown in the balance sheet at the net value.

60. Entity following relevant Revised AS should capitalise the assets at the full value and account for the grant according to the relevant applicable Standard.

Depreciation

61. The auditor should test check the calculations of depreciation and the total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. He should particularly examine whether the depreciation charge is adequate keeping in view the generally accepted bases of accounting for depreciation.

62. As per the relevant Revised AS, the auditor must check that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. Such part of an item may also have different useful life over which the asset is to be depreciated. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

63. The auditor should review the depreciation method applied to the asset at least at the end of each financial year to confirm that the depreciation charge reflects the usage. A change
in the method of depreciation should be treated appropriately as a change in an accounting estimate.

64. The auditor must verify that those assets under construction or installation are not depreciated until such time they are ready for intended use but these should be tested for impairment, if any.

**Useful Life of PPE**

65. The auditor should ensure that the management has reviewed the useful life and the residual value of the asset at least annually. The useful life is, ordinarily, estimated based on the future economic benefits embodied in the asset or such other factors prescribed by the Standard or the asset management policy of the entity.

**Impairment of PPE**

66. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. If the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount.

67. The auditor should enquire whether any compensation is receivable from third parties for items of PPE which are impaired, lost or given up and credit the same to the Profit & Loss Account when the amount becomes receivable.

68. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the asset’s recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss.

69. The increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

**Revaluation of PPE**

70. Revaluation of PPE implies restatement of their book values on the basis of systematic scientific appraisal which would include ascertainment of working condition of each unit of PPE, technical estimates of future working life and the possibility of obsolescence. This is done where the fair value of the asset can be reliably measured. As per SA 620 (Revised), “Using the Work of an Auditor’s Expert”, if expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor needs to determine whether to use the work of an auditor’s expert. For example, an expert may be used for valuation of land and buildings or plant and machinery. Such an appraisal is usually made by independent and qualified persons such as engineers, architects, etc. To the extent possible,
the auditor should examine these appraisals. As long as the appraisals appear reasonable and based on adequate facts, he is entitled to accept the revaluation made by the experts.

71. Where valuation is performed internally, the auditor should consider the basis on which it was done, the adequacy of the evidence obtained to support the valuation and the overall reasonableness of the result.

72. The auditor must also satisfy himself that the frequency of revaluation is adequate and appropriate so that the fair value of the revalued asset does not materially differ from the carrying value of the asset.

73. The auditor should verify the basis of de-recognition and the accounting treatment of an asset on disposal or when no future economic benefits are expected from its use.

**Disclosure**

74. The auditor should verify that the entity has made relevant disclosures for PPE (or class of PPE) on depreciation methods, measurement bases, details of additions and deletions, the existence of rights and restrictions, carrying amount during the course of construction, contractual commitments, impairment of assets, revaluation of assets, etc, as per the Standards applicable to the entity.

**Audit in IT environment**

75. The auditor needs to check the controls based on the use of manual or automated elements which affect the manner in which transactions are initiated, recorded, processed and reported. The IT environment benefits the entity by:

(i) Providing consistency in application of pre defined policies. For example, application of depreciation rate based on asset classification or useful life.

(ii) Enhancing timeliness and accuracy of information, for example, monthly account closure procedures like passing depreciation entries.

(iii) Generating analytical information, for example, Ratios, comparative information, etc.

(iv) Reducing risks that controls can be circumvented, for example, authorisation for purchase of fixed assets.

76. The IT environment, however, may pose control threats like:

(i) Reliance on systems which may inaccurately process data.

(ii) Unauthorised access to data leading to data loss or destruction. For example, the Fixed Assets Register may be tampered with by other personnel.

(iii) Unauthorised changes to data in master file.

(iv) Inappropriate manual intervention.
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(v) Inability to access data as required.

77. The auditor needs to determine that the automated control is functioning as intended. Subsequently, the following also need to be verified:

(a) That the changes to programs are subject to controls.
(b) That the authorised version of the program is used.
(c) Other general controls.
(d) Inspection of the record of administration of IT.
GUIDANCE NOTE ON AUDIT OF INVENTORIES

The following is the text of the Guidance Note on Audit of Inventories, issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.

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

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

Introduction

3. Inventories are tangible property held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumable stores and spare parts meant for replacement in the normal course.¹ Inventories normally comprise raw materials including components, work-in-process, finished goods including by-products, maintenance supplies, stores and spare parts, and loose tools.²

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¹ Servicing equipment, stand-by equipment and specialised spares of machinery (which are in the nature of 'insurance spares') are normally capitalised.

² The audit procedures, relating to shares debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are similar to those followed for audit of investments. Accordingly, this Guidance Note does not apply in respect of audit of shares, debentures and other securities held as stock-in-trade.

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

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

Internal Control Evaluation

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

   (a) The control procedures should provide for segregation of such functions whose combination may permit the commitment or concealment of fraud or error; for example, persons undertaking the physical verification of stocks should be different from those responsible for store-keeping in respect of those stocks.

   (b) The stores procedures should provide for the use of pre-numbered standardized forms.

---

3 The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the “Internal Control Questionnaire”, issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative discussion on internal controls in relation to inventories.
(c) There should be a system of cross-checking the data generated by different operating departments.

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

**Verification**

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

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

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

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

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

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

**Examination of Records**

10. The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item, the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents
II.18 Auditing Pronouncements

(e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

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

Attendance at Stock-taking

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

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

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

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

16. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those stocks which have a high value either individually or as a category of stocks. Proper attention should also be paid to the physical condition of inventories.
17. Ideally, there should be no movement of stocks when the physical verification is being carried out. On occasions, however, it may be necessary for the entity to continue the production, receiving, or dispatch operations during physical verification. In such circumstances, it is essential that the entity has the procedures to identify and record such movements. The auditor should review the procedures adopted by the entity to account for the movement of inventories from one location to another within the entity during stock-taking (e.g., issues from stores to production departments).

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

(a) goods purchased but not received have been included in the inventories and the liability has been provided for;

(b) goods sold but not despatched have been excluded from the inventories and credit has been taken for the sales.

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

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

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

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

(a) maintains adequate stock records that are kept up-to-date;

(b) has satisfactory procedures for physical verification of inventories, so that in the normal circumstances the programme of physical verification will cover all material items of inventories at least once during the year; and

(c) investigates and corrects all material differences between the book records and the physical counts.

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

**Confirmations from Third Parties**

23. Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the stocks of the
II.20 Auditing Pronouncements

entity are held. The auditor should also directly obtain from the third parties written confirmation of the stocks held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. A proforma letter of request for confirmation to be used in such cases is given in Appendix II to this Guidance Note. Similarly, the auditor should also obtain confirmation from such third parties for whom the entity is holding significant amount of stocks. Appendix-III to this Guidance Note gives a proforma letter of request for confirmation to be used for this purpose.

Examination of Valuation and Disclosure

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

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

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

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

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

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

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4 It may be mentioned that the Manufacturing and Other Companies (Auditor's Report) Order, 1988 uses the words “normally accepted accounting principles”.
Analytical Review Procedures

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

(i) reconciliation of quantities of opening stocks, purchases, production, sales and closing stocks;
(ii) comparison of closing stock quantities and amounts with those of the previous year;
(iii) comparison of the relationship of current year stock quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;
(iv) comparison of the composition of the closing stock (e.g., raw materials as a percentage of total stocks, work-in-process as a percentage of total stocks) with the corresponding figures for the previous year;
(v) comparison of current year gross profit ratio with the gross profit ratio for the previous year;
(vi) comparison of actual stock, purchase and sales figures with the corresponding budgeted figures, if available;
(vii) comparison of yield with the corresponding figure for the previous year;
(viii) comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;
(ix) comparison of significant ratios relating to inventories with the industry norms, if available.

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

Special Considerations in Case of Work-In-Process

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

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

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

Documentation

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

Illustrative Set of Instructions to be Issued by the Client to its Staff Responsible for Stock-Taking

(Ref. Paragraph 15)

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

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

1. Mr. AB will be in overall charge of the physical counting.

2. Messrs............., Auditors, will depute their staff to observe the work performed by us. It should be remembered that they are not responsible for any part of the stock-taking.

3. You are responsible for the physical counting of all stocks in (state here the exact area for which the person is responsible e.g., Block B of Godown No. 2, or in the open yard on south of factory, etc.). You are not concerned with similar items of stock which may be stored at other locations.

How to proceed with the work

4. At 8 A.M. you should present yourself in the office of Mr. AB where you will be handed over a bunch of inventory tags. You should ensure that you have in your possession a sufficient number for your needs. You should also have in your possession a pen, blank papers, a measuring tape, ............
Guidance Note on Audit of Inventories

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(state here any other instrument which is required for measurement, counting, weighing etc.). Please ensure that for all items in your area for which weighing or measuring is required, the necessary apparatus is available.

Procedure for tagging

5.1 You should place a tag on each pile, box, bin, etc., which is counted by you after recording the quantity, description, part number, condition of the stocks to the extent known (e.g., damaged stocks), etc., on the tag. You should proceed in proper order so as to ensure that no items are omitted. When the work of counting is completed you should hand over the remaining tags including soiled and damaged tags to Mr. PQ.

5.2 All items are required to be measured, weighed or counted in order to ascertain the exact quantity on hand. However, in respect of small items of insignificant value, such as bolts, nuts (state here any other items which are known to be of small value), the quantities on hand may be estimated without actual counting etc. In the latter case, please state "estimated" on the tag.

5.3 Please ensure that proper identification is made by part number, description, etc., and that in the case of work-in-process, the last operation performed is clearly specified in accordance with the schedule attached to this Memorandum. No movement of any stock from one location to another should take place during the period of stock checking.

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

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

5.6 After obtaining the permission of the auditors\(^5\), instructions will be issued for the removal of the tags and a suitable person should be sent around in each department to detach the detachable portion of the tags, leaving the counterpart in the proper position. When they are collected, all such tags should be brought back to a central location, placed in serial order and tallied with the schedule prepared by Mr. PQ. After this has been done, the tags will be released to the Accounts Department which is concerned with the preparation of the inventory. Later on, when the inventory has been prepared, a check should be possible to see whether all the tags have been listed.

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

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

\(^5\) It is presumed that the auditors or their representatives are present at the time of stock-taking.
II.24 Auditing Pronouncements

Procedure for preparing stock sheets

6.1 Separate listings under the following broad heads should be prepared:
   (i) Raw materials, including components
   (ii) Work-in-process
   (iii) Finished goods, including by-products
   (iv) Maintenance supplies and stores and spare parts
   (v) Loose tools

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

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

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

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

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

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

Stocks held by others

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

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

Work-in-Process

8.1 With regard to work-in-process, the following instructions be given to the staff members concerned:
   (i) A separate listing for work-in-process be prepared.
   (ii) The internal records kept by the entity be written up-to-date.
(iii) If the amount of work-in-process is determinable from production records, the same be kept up-to-date.

(iv) A list of opening work-in-process be kept ready at the time of stock-taking.

Appendix II

Illustrative Letter of Confirmation of Inventories Held by Others

[Ref. Paragraph 23]

(Letterhead of Entity)

[Date]

[Name and address of holder of inventories]

Dear Sir,

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

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

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

Yours faithfully,

(Signature of responsible official of the entity)
Appendix III

Illustrative Letter of Confirmation – Inventories
Held by the Entity on Behalf of Others
[Ref. Paragraph 23]

[Letterhead of Entity]

[Date]

[Name and address of owner of inventories]

Dear Sir,

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

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

Yours faithfully,

(Signature of responsible official of the entity)

Appendix IV

Representation Letter for Inventories
[Ref. Paragraph 33]

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

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

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

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

   Raw Materials (including components)  ₹________
2. All quantities were determined by actual physical count or weight or measurement that was taken under our supervision and in accordance with written instructions, on .......... (date/dates of physical verification), except as follows:

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

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

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

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

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

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

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

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

   Inventories recorded in the books as at .......... (date of balance sheet) aggregating to ₹ .......... are based upon the physical inventories taken as at .......... (date of physical verification) by actual count weight or measurement. The material discrepancies noticed on physical verification of stocks as compared to book records have been properly dealt with in the books of account and subsequent transactions recorded in the accounts fairly reflect the changes in the inventories up to .......... (balance sheet date).
8. No item of inventories has a net realizable value in the ordinary course of business which is less than the amount at which it is included in inventories.

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

<table>
<thead>
<tr>
<th>Class of Inventory</th>
<th>Basis of valuation</th>
<th>Effect of change in Basis of Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>..................</td>
<td>...................</td>
<td>........................................</td>
</tr>
<tr>
<td>..................</td>
<td>...................</td>
<td>........................................</td>
</tr>
</tbody>
</table>

Yours faithfully,

(Signature of responsible official of the entity)

**Clarification**

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

*(Refer Paragraph 33)*

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

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

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

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

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7 Published in September, 1999 issue of “The Chartered Accountant”, p.66.
GUIDANCE NOTE ON AUDIT OF INVESTMENTS*

The following is the text of the Guidance Note on Audit of Investments issued by the Auditing Practices Committee (APC)∗∗ of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.

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

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn.\(^1\) With the issuance of this Guidance Note on Audit of Investments, Chapter 4 of the Statement on Auditing Practices, titled "Investments", shall stand withdrawn. In due course of time, the entire Statement on Auditing Practices shall be withdrawn.

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\(^1\) This Guidance Note does not deal with special aspects of audit of investments of retirement benefit plans, life insurance enterprises, mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956. The special aspects of audit of investments of some of these institutions have been dealt with in other publications of the Institute, e.g., Guidance Note on Audit of Banks, Guidance Note on Audit of Companies Carrying on General Insurance Business, Guidance Note on Companies Carrying on Life Insurance Business. It may also be noted that in the case of certain types of entities, e.g., companies, banks, insurance companies, co-operative societies, etc., the question of compliance with the legal requirements assumes special importance. Appendix I to this Guidance Note contains a brief description of the main provisions of the statutes governing these types of entities in so far as they relate to investments. It may be emphasised that the Appendix is only illustrative and not exhaustive. Moreover, the legal requirements may change from time to time and, therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

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II.30 Auditing Pronouncements

Introduction

3. Investments are assets held by an entity for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing entity\(^2\). Investments are classified as ‘current investments’ and ‘long term investments’. A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A long term investment is an investment other than a current investment.\(^3\)

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

(a) Investments constitute a significant portion of the total assets of certain entities like banks, insurance companies, investment companies, trusts, etc. In other cases, the nature, quantum and type of investments may vary from case to case.

(b) Documentary evidence is generally available for audit verification. A detailed record of acquisition, disposal, etc., of the investments is usually maintained.

(c) The market values of investments may keep on fluctuating. While in the case of some investments, such fluctuations may not be wide, in the case of others, they may be significant.

(d) Physical location of documents of title to investments may be different from the one where the acquisition, disposal and recording thereof take place.

(e) Many investments are readily marketable or can be converted into cash.

Internal Control Evaluation

5. The auditor should study and evaluate the system of internal control relating to investments to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to investments.\(^4\)

(a) Control over acquisition, accretion and disposal of investments: There should be proper authority for sanction, acquisition and disposal of investments (including renunciation of rights). It should also be ensured that investments are made in accordance with the legal

\(^2\) It may be clarified that the term ‘investments’ covers only to such securities as are beneficially owned by the entity and not those held by it on behalf of others.

\(^3\) It may be clarified that inventories, as defined in Accounting Standard (AS) 2, Valuation of Inventories, issued by the Institute of Chartered Accountants of India are not investments. However, the recommendations of this Guidance Note also apply, to the extent relevant to shares, debentures and other securities held as stock-in-trade. Fixed assets (other than investment properties), as defined in Accounting Standard (AS) 10, Accounting for Fixed Assets, issued by the Institute, are also not investments.

\(^4\) The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the Internal Control Questionnaire, issued by the Institute of Chartered Accountants of India in 1976 which contains, inter alia, an illustrative list of internal controls in relation to investments.
requirements governing the entity as also with its internal regulations, e.g., the provisions of the articles of association, rules and regulations, trust deed, etc.

(b) **Safeguarding of investments:** The investments should be in the name of the entity as far as possible. The legal requirements in this behalf, if any, should be complied with. There should exist a proper system for the safe custody of all scrips or other documents of title to the investments belonging to the entity.

(c) **Controls relating to title to investments:** It should be ensured that in cases where the title does not pass on to the entity immediately on acquisition, the same is transferred to the entity in due course of time, along with the benefits that might have accrued since the acquisition of the investments. It should be ensured that there is no undue time-lag in the execution of various stages of the transactions.

(d) **Information controls:** These controls should ensure that reliable information is available for recording acquisitions (including by way of conversion of securities, right issues or other entitlements, under schemes of amalgamation, acquisition, etc.), accretions and disposals, and for ascertaining the market values etc. Detailed records regarding acquisition, disposal etc. of the investments should be maintained along with proper documentation.

**Verification**

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

(a) verification of transactions;

(b) physical inspection;

(c) examination of valuation and disclosure; and

(d) analytical review procedures.

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

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

**Verification of Transactions**

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

9. The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence. The auditor should pay special attention to ascertaining whether the investments have been purchased or sold *cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right* or *cum-bonus/ex-bonus*. He should check whether proper adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

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

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

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

**Physical Inspection**

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

14. The depository services and scripless trading are becoming increasingly popular in India. Depository services involve custody of documents of title to investments such as certificates, scrips and deeds and thus avoid their physical handling by the investor. The Public Debt Office of the Reserve Bank of India offers such services to facilitate trading in Government Securities. Authorised institutions such as banks, financial institutions etc., which have individual ledger accounts with the Public Debt Office can trade in government securities between themselves by issuing and accepting Bankers' Receipts. In case of such transactions, the auditor should verify the periodic reconciliation of balances as per the records of the entity and those as per the Public Debt Office.
15. Apart from the Public Debt Office, there are now a number of other custodial
organisations whose services are being utilised by banks, large investors, institutional
investors, mutual funds etc. The concept of the National Depository System (NDS) is also
under development. This system is aimed at eliminating physical movement of securities for
purchases and sales. Wherever the services of any of these custodial or depository
organisations are being used by the entity under audit, the auditor should redesign his audit
procedures to ensure that there is an effective system of periodic reconciliation of balances as
per the records of the entity and those as per the records of the custodial or depository
organisation. The auditor should also examine the certificates issued by such organisations
confirming the holdings of the entity. The concept of scripless trading being introduced by the
National Stock Exchange and the OTC Exchange of India also envisage elimination of
movement of title deeds of securities. In such cases, the auditor should verify the interim and
other acknowledgments issued by dealers as well as the year-end confirmation certificates of
the depository organisations.

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

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

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

19. If the investments are held otherwise than in the name of the entity (e.g., in the name of
nominees/trustees), the auditor should ascertain the reasons for the same and examine the
relevant documentary evidence (e.g., written confirmations from the nominees, trustees, etc.)
supporting the real/beneficial interest of the entity in the investments.
20. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, in the case of a company, the auditor should also carry out the procedures outlined in paragraphs 21-23 below.

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

22. The auditor should keep in mind the provisions of section 227(1A)(c) which requires that the auditor of a company, not being an investment company within the meaning of section 372 of the Companies Act, 1956 or a banking company, should enquire whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they are purchased by the company.5

23. In case the entity is a finance, investment, chit fund, nidhi or mutual benefit company and is dealing or trading in shares, securities, debentures or other investments, the auditor has to state in his report (by virtue of the requirements of the Manufacturing and Other Companies (Auditor's Report) Order, 19886, issued under section 227(4A) of the Companies Act, 1956) whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein as also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemptions granted under section 49 of the Companies Act, 1956.7

Immovable Properties

24. Where immovable properties are held as investments, the auditor should verify them in the same manner as in the case of immovable properties held as fixed assets.8

Examination of Valuation and Disclosure

25. The auditor should satisfy himself that the investments have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.9 Appendix III to this Guidance Note discusses, by way of illustration, the disclosure requirements of some of the Acts. The auditor should also examine whether the method of valuation followed by the entity is consistently applied.

5 For a detailed discussion on this aspect reference may be made to the Statement on Qualifications in Auditor’s Report, issued by the Institute of Chartered Accountants of India.
6 Currently, the Companies (Auditor’s Report) Order, 2003 is in force in terms of section 227(4A) of the Companies Act, 1956.
7 For a detailed discussion on this aspect, reference may be made to the Statement on the Companies (Auditor’s Report) Order, 2003, issued by the Institute of Chartered Accountants of India.
8 Reference may be made in this regard to the Guidance Note on Audit of Fixed Assets, issued by the Institute of Chartered Accountants of India.
9 Reference may be made in this regard to Accounting Standard 13, Accounting for Investments, issued by the Institute of Chartered Accountants of India.
26. The auditor should examine whether, in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty, brokerage, etc., is included in the cost of investments.

27. The auditor may ascertain the market value of the quoted securities from official quotations of the stock exchange. In case of unquoted securities, the auditor should ascertain the method adopted by the entity for determining the market value of such securities. He should examine whether the method adopted by the entity is one of the recognised methods of valuation of securities such as break-up value method, capitalisation of yield method, yield to maturity method, etc. In the case of investments other than in the form of securities (e.g., rare paintings), the auditor should examine that the market value has been ascertained on the basis of authentic market reports.

**Analytical Review Procedures**

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

**Management Representations**

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

**Documentation**

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

Legal Requirements Relating to Investments
(Ref. Paragraph 2)

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

Provisions of the Companies Act, 1956

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

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

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

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

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

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

Provisions of the Banking Regulation Act, 1949

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

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

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

**Provisions of the Insurance Act, 1938**

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

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

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

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

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

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

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

An insurer cannot invest or keep invested any part of his assets in the shares or debentures of any private company.
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Provisions of the Cooperative Societies Act, 1912

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

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

Appendix II

Illustrative Letter of Confirmation – Investments Held by Banks

(Ref. Paragraph 17)

[Letterhead of entity]

[Date]

............................... (Bank)

...............................

Dear Sirs,

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

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

We would request you to state NIL wherever applicable.

Yours faithfully,

(to be signed by person authorised to operate accounts)
Appendix III

Disclosure Requirements Relating to Investments

(Ref. Paragraph 25)

To illustrate the manner of disclosure of investments in the financial statements, this Appendix discusses the requirements of the Companies Act, 1956, the Banking Regulation Act, 1949, and the Insurance Act, 1938, insofar as they relate to disclosure of information regarding investments in the financial statements prepared and presented in accordance with the provisions of these statutes. As regards the co-operative societies, the form and content of their financial statements are governed by the rules framed by the State Government concerned. It may be emphasised that, in every case, there should be an adequate disclosure of all relevant information to facilitate proper understanding of the financial statements by the users.

Requirements of the Companies Act, 1956

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

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

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

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

Requirements of the Banking Regulation Act, 1949

The Third Schedule to the Banking Regulation Act, 1949, requires the investments to be classified under the following heads for the purpose of balance sheet presentation:
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I. Investments in India in
   (i)  Government securities
   (ii) Other approved Securities
   (iii) Shares
   (iv)  Debentures and Bonds
   (v)  Subsidiaries and/or joint ventures
   (vi)  Others (to be specified)
   Total:

II. Investments outside India in
   (i)  Government securities (including local authorities)
   (ii) Subsidiaries and/or joint ventures abroad
   (iii) Other investments (to be specified)
   Total:
   Grand Total: (I &II)

Requirements of the Insurance Act, 1938

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

- Deposit with the Reserve Bank of India (Securities to be specified)
- Indian Government Securities
- State Government Securities
- British, British Colonial and British Dominion Government Securities
- Foreign Government Securities
- Indian Municipal Securities
- British and Colonial Securities
- Foreign Securities
- Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the Indian Government or a State Government
- Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the British or any Colonial Government
- Bonds, Debentures, stocks and other securities whereon interest is guaranteed by any Foreign Government
- Debentures of any railway in India
- Debentures of any railway out of India
- Preference or guaranteed shares of any railway in India
- Preference or guaranteed shares of any railway out of India
- Railway Ordinary Stocks (i) in India (ii) out of India
- Other Debentures and Debenture stock of companies incorporated (i) in India (ii) out of India
Other guaranteed and preference stocks and shares of companies incorporated (i) in India (ii) out of India
Other ordinary stocks and shares of companies incorporated (i) in India (ii) out of India
Holdings in Subsidiary companies

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

Appendix IV

Representation Letter for Investments

(Ref. Paragraph 29)

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

(Letterhead of Entity)

[Date]

[Name and Address of the Auditor]

Dear Sir,

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

1. The current investments as appearing in the balance sheet consist of only such investments as are by their nature readily realisable and intended to be held for not more than one year from the respective dates on which they were made. All other investments have been shown in the balance sheet as 'long-term investments'.

2. Current investments have been valued at the lower of cost and fair value. Long-term investments have been valued at cost, except that any permanent diminution in their value has been provided for in ascertaining their carrying amount.

3. In respect of offers of right issues received during the year, the rights have been either been subscribed to, or renounced or allowed to lapse. In no case have they been renounced in favour of third parties without consideration which has been properly accounted for in the books of account.

4. All the investments produced to you for physical verification belong to the entity and they do not include any investments held on behalf of any other person.

5. The entity has clear title to all its investments including such investments which are in the process of being registered in the name of the entity or which are not held in the name of the entity. There are no charges against the investments of the entity except those appearing in the records of the entity.

Yours faithfully,

(Signature of responsible official of the entity)
GUIDANCE NOTE ON AUDIT OF DEBTORS, LOANS AND ADVANCES*

The following is the text of the Guidance Note on Audit of Debtors, Loans and Advances issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.

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

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

Introduction

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

** Now known as the Auditing and Assurance Standards Board (AASB).
bills of exchange, promissory notes and similar other instruments, evidencing debtors, loans and advances.

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

**Internal Control Evaluation**

5. The auditor should study and evaluate the system of internal control relating to debtors, loans and advances, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to debtors, loans and advances.¹

(a) *In respect of debtors*

(i) The basis on which credit limits for customers are to be determined should be clearly laid down. The credit limits fixed in respect of individual customers should be approved by an official independent of the sales department. These limits should be checked before orders are accepted from the customers. There should also be a system of periodic review of the credit limits.

(ii) The procedure should ensure prompt recording of debts and realisations and of linking receipts with outstandings.

(iii) There should be a procedure for preparation of aging schedule of debtors at regular intervals. The schedules should be reviewed by a responsible official and necessary action initiated in respect of overdue accounts.

(iv) Statements of account should be sent to all debtors at periodic intervals. They should be prepared and despatched by a person independent of the ledger-keeper. The debtors should be requested to confirm the balances as per the statements with reference to their own records. The confirmations received should be reviewed by a person independent of the ledger-keeper and the person responsible for preparing the statements of account, and necessary action taken in case of discrepancies.

(v) All material adjustments in debtors' accounts, particularly those relating to rebates, allowances, commissions etc., should require approval of the competent authority. Similarly, any write-off of bad debts should require approval of the competent authority.

¹ The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chattered Accountants of India in 1976, which contains an illustrative discussion on internal controls in relation to debtors and loans and advances.
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(vi) There should be a system of periodic reconciliation of various debtor balances with related control accounts.

(b) In respect of loans and advances

(i) As far as possible, the system should specify the following:
   - total amount up to which loans may be made;
   - the purposes for which loans may be made;
   - maximum amount of loans which may be made for each such purpose in individual cases;
   - the terms on which such loans may be made;
   - the persons who are authorized to make loans;
   - procedure for ensuring compliance with relevant legal requirements.

(ii) All variations in the terms of loans and advances should be duly approved in writing by the competent authority.

(iii) Where security is taken against the loans, the form and adequacy of security should be reviewed by a responsible official.

(iv) The loan and security documents should be kept in safe custody of a responsible official. A record of all such documents should be maintained and the documents should be periodically verified with reference to such records.

(v) The system should provide for identification of cases where principal and/or interest have become overdue or where any other terms are not being complied with.

(vi) Confirmation of balances should be obtained at periodic intervals in the same manner as in the case of debtors.

Verification

6. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices (SAP) 5, Audit Evidence). In carrying out an audit of debtors, loans and advances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management’s assertions regarding the following:

Existence - that all amounts recorded in respect of debtors, loans and advances are outstanding as at the date of the balance sheet.

Completeness - that there are no unrecorded debtors, loans and advances.

Valuation - that the stated basis of valuation of debtors, loans and advances is appropriate and properly applied, and that the recoverability of debtors, loans and advances is recognised in their valuation.
Disclosure that the debtors, loans and advances are disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

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

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

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

Examination of Records

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

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

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

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

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

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

(a) The terms of credit have been repeatedly ignored.
(b) There is stagnation, or lack of healthy turnover, in the account.
(c) Payments are being received but the balance is continuously increasing.
(d) Payments, though being received regularly, are quite small in relation to the total outstanding balance.
(e) An old bill has been partly paid (or not paid), while later bills have been fully settled.
(f) The cheques received from the debtor have been repeatedly dishonoured.
(g) The debt is under litigation, arbitration, or dispute.
(h) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues e.g., a debtor has either become insolvent, or has closed down his business, or is not traceable.
(i) Amounts due from employees, which have not been repaid on termination of employment.
(j) Collection is barred by statute of limitation.

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

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

14. The auditor should examine whether the contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.2

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

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

16. In the case of loans and advances, an important aspect to be examined by the auditor is whether the entity is empowered to make loans. In many cases, the statute governing the entity may contain restrictions or conditions about the amount of loans, purposes for which loans may be granted, parties to which loans may be granted etc. Similarly, the internal regulations of the entity may also prescribe the procedure to be followed for making the loans. For instance, in the case of

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2 Reference may be made in this regard to Accounting Standard (AS) 4, *Contingencies and Events Occurring after the Balance Sheet Date*, issued by the Institute of Chartered Accountants of India.
companies, sections 292, 295 and 370 place restrictions on the making of loans by companies.\(^3\) The competence of the borrower to receive the loan may also affect the legality and, hence, the recoverability of the loan. The auditor should examine the loan documents and other evidence with reference to the above while determining the legality and recoverability of the loans made by the entity.

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

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

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

**Direct Confirmation Procedure**

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

\(^3\) For a detailed study of this aspect, reference may be made to the Institute's publication titled \textit{A Guide to Company Audit}. Similarly, in the case of entities like banks, insurance companies, etc., reference may be made to the relevant publication(s) of the Institute, e.g., \textit{Guidance Note on Audit of Banks}, \textit{Guidance Note on Audit of Companies Carrying on General Insurance Business}, \textit{Guidance Note on Companies Carrying on Life Insurance Business}, \textit{Guide to Audit of Cooperative Societies}, etc.
21. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain debtors. In such cases, the auditor should consider whether there are valid grounds for such a request. For example, the management may explain the reason as being the fact that there is a dispute with the particular debtor and the request for confirmation may aggravate sensitive negotiations between the entity and the debtor. Before accepting a refusal as justified, the auditor should examine any available evidence to support the management's explanations, e.g., correspondence between the entity and the debtor. In such a case, alternative procedures should be applied to debtors not subjected to confirmation. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

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

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

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

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

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

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

28. Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous, this may be done on a sample basis. The sample list of debtors to be circularized, in order to be meaningful, should be based on a complete list of all debtor accounts. While selecting the debtors to be circularized, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor should select accounts in respect of which provisions have been made or balances have been written off during the period under audit or earlier years and request confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with nil balances. The nature of the entity's business (e.g., the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.

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

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

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

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

**Analytical Review Procedures**

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

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

(b) comparison of the relationship between current year debtor balances and the current year sales with the corresponding figures for the previous year;

(c) comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;

(d) comparison of current year's aging schedule with the corresponding figures for the previous year;

(f) comparison of significant ratios relating to debtors, loans and advances with the similar ratios for other firms in the same industry, if available;

(g) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available.

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

**Disclosure**

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

**Management Representations**

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

**Documentation**

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

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**Appendix I**

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

[Ref. Paragraph 25]

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

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

<table>
<thead>
<tr>
<th>Invoice No.</th>
<th>Date</th>
<th>Order Reference or Acceptance or Tender No. etc. (To be used Particularly for Government Customers)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Total</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Less: Advance received</td>
<td>_______</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Net Amount due by you (`)</td>
<td>_______</td>
</tr>
</tbody>
</table>

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

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

Kindly return this form in its entirety.

Yours Faithfully,

(Signature of responsible official of the entity)

(Do not perforate the form at this point)

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4 In case the list of invoices forming the balance is too large, these details may not be given.

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II.52 Auditing Pronouncements

(Name and Address of entity)

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

OR

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

<table>
<thead>
<tr>
<th>Invoice No.</th>
<th>Date</th>
<th>Order Reference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>____</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>______</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>______</td>
</tr>
</tbody>
</table>

Date (Signature of debtor/responsible official)

Appendix II

Illustrative Letter of Confirmation to be Sent to Debtors Negative Form

[Ref. Paragraph 26]

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly write directly to our auditors (name and address of the auditors) if the balance of ₹ due by you as on ______ as shown by our books, is not correct, giving details of the differences. The details of the balance are as under:5

<table>
<thead>
<tr>
<th>Invoice No.</th>
<th>Date</th>
<th>Order Reference or Acceptance or Tender No. etc. (To be used particularly for Government Customers)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>______</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>______</td>
</tr>
</tbody>
</table>

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

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

Yours faithfully,

(Signature of responsible official of the entity)

5 In case the list of invoices forming the balance is too large, these details may not be given.
Appendix II

Representation Letter for Debtors, Loans and Advances

[Ref. Paragraph 35]

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

[Letterhead of Entity]

[Name and Address of the Auditor]

Dear Sir,

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

Sundry Debtors ₹
Loans and Advances\(^6\) ₹

Yours faithfully,

(Signature of responsible official of the entity)

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\(^6\) It may be pointed out that a similar certificate regarding deposits made by the entity may also be obtained by the auditor in appropriate cases.
GUIDANCE NOTE ON AUDIT OF CASH BANK BALANCES*

The following is the text of the Guidance Note on Audit of Cash and Bank Balances issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.

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

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Cash and Bank Balances, Chapter 6 of the Statement on Auditing Practices, titled 'Cash and Bank Balances', shall stand withdrawn.¹ In due course of time, the entire Statement on Auditing Practices shall be withdrawn.

Introduction

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

4. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices 5, Audit Evidence). In carrying out an audit of cash and bank balances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management’s assertions regarding the following:

   Existence - that recorded cash and bank balances exist as at the year-end.

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** Now known as the Auditing and Assurance Standards Board (AASB).
¹ The special aspects of audit of cash and bank balances in the case of banks are dealt with in the Guidance Note on Audit of Banks (edn. 2001).

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Rights and obligations - that recorded cash and bank balances represent the assets of the entity.

Completeness - that there are no unrecorded cash and bank balances.

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

**Internal Control Evaluation**

5. The auditor should study and evaluate the system of internal control relating to cash and bank balances to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to cash and bank balances.²

(a) segregation of duties relating to authorisation of transactions, handling of cash/issuance of cheques and writing of books of account, and rotation of the duties periodically;

(b) proper authorisation of cash and banking transactions;

(c) daily recording of cash transactions;

(d) safeguards such as restrictive crossing of cheques, use of pre-printed, pre-numbered forms;

(e) periodic reconciliation of bank balances;

(f) reconciliation of cash-on-hand with book balance on a daily basis or at other appropriate intervals, including surprise checks by higher authorities;

(g) safe custody of cash, cheque books, receipt books etc.; and

(h) cash/fidelity insurance.

**Verification**

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

**Verification of Cash Balances**

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

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² The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the **Internal Control Questionnaire**, issued by the Institute of Chartered Accountants of India in 1976 which contains, **inter alia**, an illustrative list of internal controls in relation to cash and bank balances.
or around the date of the balance sheet, the auditor should also carry out surprise verification of cash during the year.

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

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

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

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

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

Verification of Bank Balances

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

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

Concerned. In such a case, the auditor should examine that the entity has reversed the relevant entries.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix

Illustrative Letter of Confirmation – Bank Balances

(Ref. Paragraph 13)

[Letterhead of Entity]

Dear Sirs,

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

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

Yours faithfully,

(Signature of person authorised to operate accounts)

3 For valuation of foreign currency held as cash-in-hand and bank balances designated in foreign currencies, reference may be made to Accounting Standard 11, Accounting for the Effects of Changes in Foreign Exchange Rates, issued by the Institute of Chartered Accountants of India.
[Name and Address of Auditors]

Dear Sirs, 

Date: ____________

Re: (Name of Client) 

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

1. Current Accounts in Credit 
   Designation of Account  Amount 

2. Overdrawn Current Accounts, Overdraft Accounts or Cash Credit Accounts. 
   Designation of Account  Amount  Security held (give brief description. In the case of securities please list fully) 

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

4. Fixed, Call and Short Deposit Accounts 
   Amount  Interest Accrued to the closing date  Due Date  Particulars of any charges of liens 

5. Investments and Other Documents of Title Held in Safe Custody 
   Designation.  Face value or number of shares held. 

6. Margin against letters of credit Guarantees issued, etc. 
   Designation of Account  Amount 

7. Bills for Collection 
   Designation of Account  Amount  Due date 

8. Bills Discounted or Purchased. 
   Name of Drawee  Amount  Due date 

9. Letters of Credit Open and Outstanding 
   In favour of  Amount not utilised  Valid upto 

10. Guarantees given on behalf of clients 
    In favour of  Amount.  Date of expiry 

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

Yours faithfully, 

Name of Bank 
Designation of Signatory
Introduction

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

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

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

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

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

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

   (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors’ resolution in this regard.

   (ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

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

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

   (i) Accounting Standard (AS) 8, Accounting for Research and Development;

   (ii) Accounting Standard (AS) 6, Depreciation Accounting, with respect to the amortisation (depreciation) of intangible assets; and

   (iii) Accounting Standard (AS) 10, Accounting for Fixed Assets - paragraphs 16.3 to 16.7, 37 and 38.

7. Since AS 26 applies to different entity from different dates, it may happen that certain enterprises, till the date the standard becomes mandatory for them may continue to defer the expenditure incurred on items that normally constitute “miscellaneous expenditure”. Once an entity applies AS 26 to account for intangible assets, the expenditure incurred on items that normally constitute miscellaneous expenditure shall be governed by the Standard, except in the case of already appearing miscellaneous expenditure in the balance sheet which is to be accounted for using paragraph 99 of AS 26.
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8. The following features of miscellaneous expenditure have an impact on the related audit procedures.
   (a) The items of expenditure included under this heading do not represent any tangible asset.
   (b) The expenditure on these items is usually of a non-recurring nature.
   (c) There is a justification for deferring the expenditure on the basis that the benefits from the expenditure can reasonably be expected as flowing into the future the amount of such benefits is reasonably determinable, and the amount of deferred expenditure does not exceed the expected future benefits related thereto.
   (d) Unless some fresh expenditure is incurred, the balance in these items reduces each year by the amount written-off in the year.

9. The auditor’s primary objective in audit of items that generally constitute miscellaneous expenditure is to satisfy himself that —
   (a) in case where some items are shown in the balance sheet under the head Miscellaneous Expenditure whether it is proper to defer the expenditure;
   (b) in case where some items are shown in balance sheet under the head 'Miscellaneous Expenditure', the period of amortisation of the expenditure is reasonable;
   (c) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral;
   (d) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue/other benefits related to the expenditure continue to exceed the amount of unamortised expenditure.
   (e) Where the entity has applied AS 26, for accounting for items that normally constitute miscellaneous expenditure, whether the same has been done in accordance with the Standard and the already appearing items under the head miscellaneous expenditure have been dealt with in accordance with paragraph 99 of AS 26.

Internal Control Evaluation

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

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

**Verification**

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

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

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

**Preliminary Expenses**

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

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

15. Paragraph 55 of AS 26 requires that expenditure on an intangible item should be recognised as an expense when it is incurred unless:
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(a) it forms part of the cost of an intangible asset that meets the recognition criteria laid down in paragraphs 19-54 of AS 26; or

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

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

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

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

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

(a) The auditor should verify whether the preliminary expenses incurred on or after the date the Standard is applied by the enterprise are entirely charged to the profit and loss account in the year in which they are incurred.

(b) In the case of preliminary expenses already appearing in the balance sheet on the date the Standard is applied, the auditor should satisfy himself that the estimate made by the management of the enterprise of the useful life of the preliminary expenses is appropriate.

(c) The auditor should verify whether the carrying amount of the preliminary expenses already appearing in the balance sheet is eliminated with a corresponding adjustment to the opening balance of the revenue reserve in case the amortisation period determined under paragraph 63 of AS 26 has already expired.
(d) The auditor should satisfy himself that the preliminary expenses already appearing in the balance sheet are being amortised in accordance with the requirements of AS 26 in case the amortisation period determined under paragraph 63 of AS 26 has not expired.

**Expenses Related to Subscription or Issue of Shares**

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

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

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

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

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

**Research and Development Expenditure**

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

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

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

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

(a) The auditor should verify the research expenditure and development expenditure with
reference to supporting documents such as purchase invoices, agreements with third
parties etc. A variety of expenses may be incurred by an enterprise during the
research phase or development phase of an enterprise. The auditor should apply the
procedures mentioned in the Guidance Note on Audit of Expenses with regard to the
items of expenditure covered therein.

(b) The auditor should verify that the expenses incurred on research or incurred during the
research phase of an internal project on or after the date the Standard is first applied
by the enterprise are entirely charged to the profit and loss account in the year in which
they are incurred;

(c) In the case of research and development expenses already appearing in the balance
sheet on the date the Standard is first applied, the auditor should satisfy himself that
the estimate made by the management of the enterprise of the useful life of such
expenses is appropriate;

(d) The auditor should verify whether the carrying amount of the research and development
expenses already appearing in the balance sheet is eliminated with a corresponding
adjustment to the opening balance of the revenue reserve in case the amortisation period
determined under paragraph 63 of AS 26 has already expired.

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

(f) The auditor should also examine that the intangible asset recognised is accounted for
in accordance with the requirements of AS 26.

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

Other Items

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

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

Disclosures

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

The following is the text of the Guidance Note on Audit of Liabilities issued by the Auditing Practices Committee (APC) of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.

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

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Liabilities, Chapter 9 of the Statement on Auditing Practices, titled 'Liabilities', shall stand withdrawn. In due course of time, the entire Statement on Auditing Practices shall be withdrawn.

Introduction

3. Liabilities are the financial obligations of an enterprise other than owners’ funds.

4. Liabilities include loans and borrowings, trade creditors and other current liabilities, deferred payment credits, instalments payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable.

5. Special considerations may apply in the case of audit of liabilities of specialised entities like banks, financial institutions and venture capital funds.

** Now known as the Auditing and Assurance Standards Board (AASB).
6. Liabilities generally constitute a significant proportion of the total sources of funds of an entity. The audit of liabilities is primarily directed at ensuring that all known liabilities have been properly accounted for, since material omission or misstatement of liabilities vitiates the true and fair view of the financial statements.

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

8. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions [see Statement on Standard Auditing Practices (SAP) 5, Audit Evidence]. In carrying out an audit of liabilities, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to satisfy himself that all known liabilities are recorded and stated at fair and reasonable amounts.

**Internal Control Evaluation**

9. The auditor should study and evaluate the system of internal control relating to liabilities to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to liabilities.\(^1\)

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

   (i) As far as possible, the following should be clearly specified:
       - the borrowing powers and limits;
       - persons authorised and competent to borrow;
       - terms of borrowings;
       - procedure for ensuring compliance with relevant legal requirements/internal regulations.

   (ii) Any variations in the terms of loans and borrowings should be truly approved/ratified in writing by competent authority.

   (iii) Security offered against loans and borrowings should be properly recorded and periodically reviewed.

   (iv) The records and documents should be kept in proper custody and reviewed periodically.

   (v) The system should bring out all cases of non-compliance with terms and conditions including amounts of principal and/or interest which have become overdue.

   (vi) Confirmation of balances should be obtained at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.

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\(^1\) The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the Internal Control Questionnaire, issued by the Institute of Chartered Accountants of India, which contains, *inter alia*, an illustrative list of internal controls in relation to creditors and borrowings.
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(vii) There should be a proper procedure for year-end valuation of loans and borrowings, especially for those designated in foreign currencies.\(^2\)

(b) In respect of Trade Creditors

(i) The procedure should ensure proper recording of transactions and facilitate the linking of payments with outstanding.

(ii) The payments made to creditors should be in line with the approved policies of the entity.

(iii) There should be specific procedures for payments against duplicate invoices or other duplicate records as well as for payments against accounts which have remained unclaimed for quite some time.

(iv) There should be a procedures for preparation of schedules of trade creditors at periodic intervals; this should be reviewed by a responsible person and necessary action initiated on overdue accounts.

(v) Statements of account should be called for creditors at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.

(vi) All adjustments in the creditors’ accounts such as those relating to claims for returns, defectives, short receipts of goods, rebates, allowances and commissions etc., should require approval of competent authority. Similarly, any write-back of creditors’ balances and escalation claims should be approved by competent authority.

(vii) There should be appropriate cut-off procedures in relation to transactions affecting the creditor accounts.

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

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

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

Verification

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

(a) examination of records;

(b) direct confirmation procedure;

(c) examination of disclosure;

(d) analytical review procedures,

(e) obtaining management representations.

\(^2\) Reference may be made in this regard to Accounting Standard 11 (revised 2003), Effects of Changes in Foreign Exchange Rates, issued by the Institute of Chartered Accountants of India.
The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, *inter alia*, on the auditor’s evaluation of the effectiveness of the related internal controls.

**Examination of records**

**Loans and Borrowings**

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

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

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

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

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

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

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

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

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

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

**Trade Creditors and Other Current Liabilities**

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

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

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

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

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

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

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

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

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

Provisions

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

30. The audit of provisions primarily involves examining the reasonableness and adequacy of the amounts provided for. The auditor should also examine that the provisions made are not in excess of what is reasonably required.
31. **Provisions for Taxes and Duties**: The adequacy of the provision for taxation for the year should be examined. The position regarding the overall outstanding liability of the entity as at the date of balance sheet should be reviewed. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. Similarly, he should examine whether excess provisions or refunds have been properly adjusted. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether any short provisions have been made good. If there is a material tax liability for which no provision is made in the accounts, the auditor should qualify his report in this respect even if the reserves are adequate to cover the liability.

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

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

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

35. **Provision for Bonus**: In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable

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3 Reference may be made in this regard to the Accounting Standard (AS) 22, *Accounting for Taxes on Income* issued by the Institute of Chartered Accountants of India.

4 Reference may be made in this regard to Accounting Standard (AS) 15, *Accounting for Retirement Benefits in the Financial Statements of Employers*, issued by the Institute of Chartered Accountants of India.
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36. **Provision for Dividends**: The auditor should examine that dividends are provided for as per applicable provisions of the relevant laws and rules framed thereunder, relevant agreements and resolutions.

37. **Other Provisions**: Where provisions are made for liabilities that may arise on account of product warranties, service contracts, performance warranties etc., the auditor should examine whether the provisions made are in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, issued by the Institute of Chartered Accountants of India. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements.

**Contingent Liabilities**

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

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

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

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

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

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5 Reference may be made in this regard to the Accounting Standard (AS) 4, **Contingencies and Events Occurring After the Balance Sheet Date**, issued by the Institute of Chartered Accountants of India.
Direct Confirmation Procedure

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

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

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

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

45. The form of requesting confirmation from the creditors may be either (a) the 'positive' form of request, wherein the creditor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request, wherein the creditor is requested to respond only if he disagrees with the balance shown.
46. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. An illustrative positive form of request letter is given in Appendix I to this Guidance Note.

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

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

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

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

51. The method of selection of the creditors to be circularised should not be revealed to the entity until the trial balance of the creditors’ ledger is handed over to the auditor. A list of creditors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to creditors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.
52. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those creditors from whom he receives no replies. In exceptional circumstances, the auditor may also correspond directly with those significant creditors from whom he receives no replies despite reminders, with intimation to the entity. In the event of inadequacy of responses received, the auditor will have to increase the extent of examination of records and analytical review procedures beyond that planned originally.

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

**Examination of Disclosure**

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

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

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

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

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

**Analytical Review Procedures**

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

   (a) comparison of closing balances of loans and borrowings, creditors, etc., with the corresponding figures for the previous year;
   (b) comparison of the relationship between current year creditor balances and the current year purchases with the corresponding figures for the previous year;
   (c) comparison of actual closing balances of loans and borrowings, creditors, etc., with the corresponding budgeted figures, if available;
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(d) comparison of current year’s aging schedule of creditors with the corresponding figures for the previous year;

(e) comparison of significant ratios relating to loans and borrowings, creditors, etc., with the similar ratios for other firms in the same industry, if available;

(f) comparison of significant ratios relating to loans and borrowings, creditors, etc. with the industry norms, if available.

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

Special Considerations in the Case of a Company

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

(a) In determining whether the loans obtained by the company are within its powers, the auditor should scrutinise its memorandum and articles of association and also examine whether the provisions of sections 292 and 293(1(d) of the Companies Act, 1956 are complied with.

(b) The auditor should examine the register of charges to ensure that charges created have been duly registered. He should also ensure that the description of such charges disclosed in the balance sheet agrees in substance with that stated in the documents creating the charges.

(c) The auditor should examine all loans taken from bodies corporate under the same management or from a company, firm or other party in which any director is interested and determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are prime facie prejudicial to the interest of the company.6

(d) Where the company has accepted deposits, the auditor should examine compliance with the relevant legal provisions, e.g., section 58A of the Companies Act, 1956 and the rules framed thereunder/directions issued by the Reserve Bank of India.

(e) In respect of unclaimed dividends, the auditor should examine whether the company has complied with the provisions of section 205A of the Companies Act, 1956 and the rules framed thereunder under regarding transfer of certain unpaid or unclaimed dividends to a special bank account/general revenue account of the Central Government.

(f) The auditor should examine whether any undisputed amounts payable in respect of income-tax, wealth tax, sales tax, customs duty and excise duty are outstanding as at the balance sheet date.

6 Reference may also be made in this regard to the Statement on the Companies (Auditor's Report) Order, 2003 issued by the Institute of Chartered Accountants of India.
for a period of more than six months from the date they became payable. If so, the auditor should report the amounts of such outstanding dues.\(^7\)

\(g\) The verification procedure to be adopted by the auditor for audit of debentures would vary from year to year, depending upon whether fresh debentures are issued and/or they are redeemed or converted into shares during the year. In case of fresh issue of debentures, the auditor should examine the memorandum and articles of association of the company and resolutions authorising the issue. He should also examine compliance with the requirements of the terms of issue and any variations thereof and necessary approvals/clearances for: the issue from authorities concerned such as SEBI, RBI etc. The auditor should also examine that proper accounts are maintained with regard to amounts received towards application, allotment and calls and that the Payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where debentures are issued at a premium/discount, the auditor should ensure that such sums are accounted for distinctly. In case of buy-back, conversion, re-issue or redemption of debentures, the auditor should examine that these are in accordance with the terms of the issue. The auditor should examine that the requirements relating to creation of debenture redemption reserve and, where applicable, sinking fund and its Investment; and other related requirements are complied with.

**Management Representations**

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

**Documentation**

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

\(^7\) Reference may also be made in this regard to the *Statement on the Companies (Auditor’s Report) Order, 2003* issued by the Institute of Chartered Accountants of India.
The following is the text of the Guidance Note on Audit of Revenue issued by the Auditing Practices Committee (APC) of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the authority of SAs.

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

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

Introduction

3. Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an entity from the sale of goods, from the rendering of services, and from the use by others of entity resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. The term ‘revenue’ covers only the gross inflow of cash, receivables or other consideration, as aforesaid, received or receivable by the entity on its own account. Amounts collected on behalf of third parties are excluded from revenue. For example, in an agency relationship, revenue from the view point of the agent is the amount of commission receivable by him and not the gross amount of cash, receivables or other consideration collected by him on behalf of the principal.
4. This Guidance Note deals with the audit of the following types of revenue (dealt with in Accounting Standard (AS) 9, *Revenue Recognition*, issued by the Institute of Chartered Accountants of India) arising in the course of the ordinary activities of an entity:

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

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

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

**Internal Control Evaluation**

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

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

**Verification**

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

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

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1 The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire" issued by the Institute of Chartered Accountants of India in 1976, which contains an illustrative list of internal controls in relation to sales.
The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

**Examination of Records**

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

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

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

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

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

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

14. In respect of sales to intermediate parties (i.e., where goods are sold to distributors, dealers or others for resale), the auditor should examine that revenue from such sales is not recognised until the significant risks and rewards of ownership have passed. However, in situations where an intermediate party is in substance an agent (e.g., a consignee), revenue should not be recognised until the related goods are sold to a third party.²

² Reference may be made to AS 1, *Disclosure of Accounting Policies*, for discussion on the concept of "substance over form".
15. Where the consideration is receivable in installments and includes an element of interest, the auditor should examine that the revenue attributable to the sale excludes the interest element.

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

(a) The auditor should examine that revenue from export sales in which consideration is receivable in a foreign currency is recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates.  

(b) The auditor should obtain a written representation from the management to the effect that the entity has complied with the legal and regulatory requirements relating to exports.

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

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

**Examination of Presentation and Disclosure**

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

**Analytical Procedures**

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

(a) Comparison, product-wise and location-wise, of revenue for the current year with the corresponding figures for previous years.

(b) Comparison of ratio of gross margin to sales for the current year with the corresponding figures for previous years.

(c) Comparison of ratio of sales returns to sales for the current year with the corresponding figures for previous years.

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3 This Accounting Standard has been revised in 2003. The title of the revised Accounting Standard is “Effects of Changes in Foreign Exchange Rates”.

4 Reference may be made in this regard to AAS 11 (SA 580), Representations by Management.
(d) Comparison of ratio of trade discount to sales for the current year with the corresponding figures for previous years.

(e) Comparison of ratio of excise duty/sales tax/export incentives to sales for the current year with the corresponding figures for previous years.

(f) Comparison, product-wise and location-wise, of quantity sold during the year with the corresponding figures for previous years.

(g) Product-wise reconciliation of quantity sold during the year with opening stock, purchases/production and closing stock.

(h) Comparison of dividend/interest/royalty for the current year with the corresponding figures for previous years.

(i) Comparison of ratio of income on investments to average investments for the current year (separately for each major type of investment) with the corresponding figures for previous years.

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

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

Special Considerations in the Case of a Company

21. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. For example, as required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988, issued under section 227(4A) of the Act, the auditor should examine whether the transactions of sale of goods, materials and services and purchase of goods and materials, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Act, and exceeding the limits specified in the Order, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials or services or the prices at which transactions for similar goods or services have been made with other parties. 5

Documentation

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

5 Reference may be made in this regard to Statement on the Manufacturing and Other Companies (Auditor's Report) Order, 1988.
GUIDANCE NOTE ON AUDIT OF EXPENSES*

The following is the text of the Guidance Note on “Audit of Expenses” issued by the Auditing Practices Committee of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, which sets out the authority of SAs.

Introduction
1. An expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period. The expression "cost" means the amount of expenditure incurred on or attributable to a specified article, product or activity.

2. Expenses are recognised by the following approaches:
   (a) Identification with revenue transactions
       Costs directly associated with the revenue recognised during the relevant period are considered as expenses and are charged to income for the period.
   (b) Identification with a period of time
       In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time.¹ Such costs are regarded as ‘period costs’ and are expensed in the relevant period, e.g. salaries, telephone, travelling, depreciation on office building, normal interest, etc. Similarly, the costs, the benefits of which, do not clearly extend beyond the accounting period are also charged as expenses.

3. The following features of expenses affect the nature, timing and extent of the related audit procedures:
   (a) In the case of most items of expenses, documentary evidence originating from third parties is available.

* Published in November, 2001 issue of ‘The Chartered Accountant’.
¹ Reference may be made in this regard to Guidance Note on Accrual Basis of Accounting.

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(b) The nature and relative significance of various items of expenses usually differ from one enterprise to another, depending primarily on the nature of operations carried out by them. For example, in the case of most manufacturing enterprises, the principal items of expenses would include the cost of raw materials consumed, labour cost and other conversion costs. On the other hand, in the case of a trading enterprise, the principal items of expenses would generally be the cost of goods sold. In the case of an enterprise supplying, providing, maintaining and operating any services, the principal items of expense would include personnel and professional expenses, office maintenance, etc.

(c) The amount of some expenses has a logical relationship with certain other financial statement items while the amount of some other expenses does not have such a relationship. For example, in an enterprise where the production process is standardised, the consumption of raw materials (and, therefore, the cost of raw materials consumed) has a logical relationship with the quantum of output. Similarly, the proportion of various constituents of cost of production is expected to remain more or less constant in the absence of known conditions to the contrary. Likewise, proportion of the amount of interest for a period to the amount of loans outstanding during the period is expected to vary within certain specific limits. On the other hand, the expenditure on research and development often has little relationship with other items in the financial statements.

(d) The amount of some items of expenses (e.g., gratuity, taxes, bonus, etc.) is significantly affected by applicable laws.

4. In an audit, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see SAP 5, Audit Evidence). In carrying out an audit of expenses, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

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

5. In view of the divergence in the nature of expenses incurred by different enterprises, it is not possible to describe the audit procedures applicable in carrying out an audit of expenses in all situations. This Guidance Note provides guidance on procedures to be employed in carrying out an audit of expenses which would be applicable in the case of most enterprises. It is recognised,
however, that audit procedures different from or additional to those described in this Guidance Note may be necessary in a particular case, depending upon its specific facts and circumstances.

**Internal Control Evaluation**

6. The auditor should study and evaluate the system of internal control relating to expenses, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to expenses:²

(a) The systems and procedures relating to incurring of expenses including authorisation procedures.

(b) Accounting procedures relating to recognition of expenses.

(c) Existence of periodic reports on actual performance vis a vis budgets and internal management reports, if any.

**Verification**

7. Verification of expenses may be carried out by employing the procedures, viz., (a) examination of records; and (b) analytical procedures. The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls. The auditor should examine whether the basis of recognition of expenses by the entity is in accordance with the recognised accounting principles.

(a) **Examination of Records**

8. Examination of records and documents is one of the most important techniques of auditing. An auditor has to examine a large number of documents in the course of an audit since most transactions are supported only by documentary evidence. The accounting systems of business enterprises are so designed that documentary evidence is created in respect of each transaction. The auditor should carry out an examination of the relevant records to satisfy himself about the validity, accuracy and other assertions with regard to various expenses incurred by the entity. The extent of such examination would depend on the auditor’s evaluation of the efficacy of internal controls.

(b) **Analytical Procedures**

9. The auditor should conduct analytical procedures which involve analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.³

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² The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to petty cash, cash and bank payments, salaries and wages and purchases.

³ Refer to Auditing and Assurance Standard (AAS) 14 (SA 520), Analytical Procedures.
10. The following paragraphs describe the audit procedures applicable in respect of various items of expenses.

**Goods and Raw Materials Consumed**

11. The auditor’s examination of the cost of goods, stores and materials consumed during the year would involve, *inter alia*, examination of purchases of goods and materials made during the year as well as of purchase returns and of opening and closing inventories.

**Purchases and Purchase Returns**

12. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to purchases and purchase returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the selected receipt documents (such as goods received notes) pertaining to a few days immediately before the year-end and verify that the related purchase invoices have been recorded as purchases of the current year. The auditor should pay particular attention to the cut-off procedures relating to purchases, both indigenous and imported, to determine whether these procedures ensure recognition of purchases at the time the significant risks and rewards of ownership of the related goods pass on to the entity.

13. The auditor should examine selected entries in the purchase journal with reference to the related purchase invoices, receipt records and other supporting documents such as the purchase orders. The auditor should also trace the selected entries to the suppliers’ account.

14. While examining purchase invoices, the auditor should examine whether subsidies, rebates, duty drawbacks or other similar items have been properly accounted for. As per AS 2, costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

15. The auditor should also examine selected receipt records with reference to related purchase invoices and the purchase journal.

16. The auditor should examine selected entries of purchase returns with reference to the goods returned notes, debit notes and entries in the suppliers’ accounts. Similarly, the auditor should examine selected debit notes with reference to purchase returns, goods returned notes, and entries in the suppliers’ accounts.

17. In case of transactions between related parties, the auditor should pay special attention to nature and description of such transactions.⁴

18. The auditor should obtain a representation from the management to the effect that the entity has complied with the legal and regulatory requirements, if any. When the auditor

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⁴ Refer to Accounting Standard (AS) 18, Related Party Disclosures.
becomes aware of non-compliance, the auditor should obtain sufficient information to evaluate the possible effect in the financial statements. The auditor should also consider communication/reporting of non-compliance with the management including audit committee, users of financial statements and to regulatory authorities, as may be appropriate.  

19. In respect of imports, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic purchases.

(a) Besides examining the usual documents relating to purchases, the auditor should also examine such documents as bill of lading, custom documents, etc., which are specific to import transactions.

(b) The auditor should pay special attention to the terms of import relating to the incidence of charges like insurance and freight, i.e., whether the imports are on C.I.F. basis, or F.O.B. basis, or some other basis.

(c) The auditor should examine that imports for which consideration is payable in a foreign currency are recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates.

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

(a) Comparison, item-wise and location-wise, both quantity and value, of purchases for the current year/period with the corresponding figures for previous years/periods.

(b) Comparison of ratio of gross margin to sales for the current year/period with the corresponding figures for previous years/periods.

(c) Comparison of ratio of purchase returns to purchases for the current year/period with the corresponding figures for previous years/periods.

(d) Product-wise reconciliation of quantity sold during the year/period with opening stock, purchases/production and closing stock.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. In case segment information is available, the above procedures may be carried out for each segment.

21. The auditor should also verify payments subsequent to the date of the balance sheet to identify any purchases which have not been recorded in the books of account.

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5 Refer to Auditing and Assurance Standard (AAS) 21 (SA 250), Consideration of Laws and Regulations in an Audit of Financial Statements.
Wages and Salaries

22. The auditor should examine the entries in the payroll/wage sheets with reference to relevant records, e.g., employee’s records maintained by the personnel department showing details of pay such as basic pay, allowances, annual increments, leaves availed, etc. Special attention may also be paid by auditor in respect of new employees joining the entity during the year. Similarly, the payroll may also be examined with reference to the time records/attendance records and leave records maintained by the personnel department. The deductions made in respect of income-tax, provident fund, Employees’ State Insurance (ESI), welfare schemes, health schemes, etc., may be examined with reference to the returns submitted to the authorities concerned and the receipts/acknowledgments issued by such authorities.

23. The auditor should examine whether any legal, regulatory or contractual requirements having a bearing on the rate or amount of wages and salaries have been complied with. Similar considerations would also apply to payments made to a contractor for hire of labour. Such requirements would include, *inter alia*, the provisions of the Minimum Wages Act, 1948, agreement with the employees, award of competent authority and judicial rulings.

24. In the case of senior management officials, the auditor should pay particular attention to determining whether the salaries payable are as per the terms of contract with the employees concerned. Special requirements of terms of contract such as granting stock options (as per schemes formulated by SEBI), availing leave encashment, total amount payable annually including ex-gratia, etc., should be specifically looked into.

25. In the case of casual labour, besides carrying out the other audit procedures, the auditor should specifically examine the sanction of the competent authority for employment of such labour and ascertain whether such employees are retained as per the time rate or piece-rate basis. In appropriate cases, the auditor may pay a surprise visit to the sites where the casual labour is employed to assess the correctness of the attendance records maintained in respect of such labour. In cases where complete outsourcing of labour has been given to an outside agency, the terms of agreement and compliance thereof would be examined.

26. The auditor should obtain a list of employees who have retired or otherwise left the services of the entity during the period under audit and examine that they have not been included in the payroll.

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

   (a) comparison of wage bill for the year/period with the wage bill of previous years/periods;

   (b) comparison of the monthly wages and salaries of a month with other months during the year/period and with the corresponding month of the previous years/periods;

   (c) comparison of the wage bill for each department/unit for the current year/period with the corresponding figures for previous years/periods;
(d) comparison of the ratios of wages and salaries to sales for the current year/period with the corresponding figures for the previous years/periods;

(e) comparison of the ratio of wages and salaries to cost of production for the current year/period with the corresponding figures for previous years/periods;

(f) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the corresponding figures for previous years/periods;

(g) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing provident fund;

(h) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the corresponding figure for previous years/periods;

(i) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing the ESI.

**Bonus**

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

**Retirement Benefits**

29. The auditor should examine whether the entity is liable to pay any retirement benefits to its employees such as provident fund, superannuation/pension, gratuity, etc., whether in pursuance of requirements of any law and/or in terms of agreement with the employees. If so, the auditor should examine whether the amount payable has been computed in accordance with the relevant legal and/or contractual requirements. In respect of gratuity/pension, the auditor should specifically examine whether the provision for accruing gratuity/pension liability has been made by the entity. The auditor should examine the adequacy of provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine that the method followed by it, say, group gratuity insurance scheme taken by the entity, for calculating the accrued liability for gratuity is rational.

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6 Attention is invited in this regard to Accounting Standard (AS) 15, *Accounting for Retirement Benefits in the Financial Statements of Employers*.

7 Attention is also invited in this regard to Auditing and Assurance Standard (AAS) 9 (SA 620), *Using the Work of an Expert*. 
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Other Conversion Costs

30. The auditor should verify the other conversion costs (such as power and fuel, processing charges, etc.) with reference to the supporting documents and related agreements. In case the material is sent outside to third parties for processing, necessary charges including existence of materials, wastage, etc., need to be ascertained and accounted for. In addition, the auditor may also compare the amount of expense on a particular item with the corresponding figure for previous years. Similarly, he may work out the ratios of different items of conversion costs to total cost of production for the current year and compare the same with the corresponding figures for previous years.

Establishment and General Administrative Expenses

31. The auditor should verify establishment expenses and general administrative expenses such as insurance, rent, rates, conveyance, travelling, telephone, entertainment, printing and stationery, general expenses, etc., with reference to the sanction of the competent authority, the supporting documents, related agreements and the rules and regulations followed by the entity. The auditor may also compare the amounts of these expenses with the corresponding figures for previous years. Similarly, he may work out the ratios of different items of expenses to sales for the current year and compare the same with the corresponding figures for previous years.

Interest and Financial charges

32. The auditor should verify the amount of interest expense for the year with reference to the terms and conditions of relevant agreements. The auditor may also work out the ratio of interest expense for the year to average interest-bearing loans and advances outstanding during the year and compare it with the corresponding figure for previous years and reconcile the same. The auditor should particularly examine that interest as well as other financing costs such as commitment fees on funds borrowed for a qualifying asset included in the gross book value of the asset to which they relate and have not been charged to the Profit and Loss Account of the period in which they are incurred. If the entity has paid any penal interest, it should also be examined. Such interest should be disclosed as part of normal interest. The auditor should consider, having regard to the materiality, whether it requires separate disclosure.

Depreciation

33. The auditor should check the calculation of depreciation. The total depreciation arrived at should be compared with that of previous years to identify reasons for variations. The auditor should particularly examine whether the depreciation charge having regard to rate of depreciation and method of depreciation followed consistently is adequate keeping in view the generally accepted bases of accounting for depreciation. Alternatively, the auditor may consider qualifying his report. In case, assets have been revalued by entity during the year, the auditor should ensure that the depreciation has been computed properly.

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8 Attention is invited Accounting Standard (AS) 16, Borrowing Costs.
9 Attention is also drawn to Accounting Standard (AS) 6, Depreciation Accounting.
Research and Development Expenses

34. The auditor should verify various items of expenses incurred on research and development with reference to supporting documents and related agreements. For example, the cost of materials consumed for research and development may be verified with reference to such documents as purchase invoices, goods received notes, records relating to issue of materials, etc. The auditor should particularly examine whether the accounting policy followed by the entity regarding treatment of research and development costs is in accordance with Accounting Standard (AS) 8, *Accounting for Research and Development*.

35. The auditor should examine whether the deferral meets the appropriate legal requirements, if any. If an accounting policy for deferral of research and developments is adopted, it should be applied to all such projects which meet the criteria laid down for deferral under AS 8. The auditor should examine whether the criteria laid down in AS 8 which previously justified the deferral of certain research and development costs no longer apply, the unamortised balance has been charged as an expense of the year. Similarly, the auditor should examine that where the criteria for deferral continue to be met but the amount of unamortised balance of the deferred research and development costs and other relevant costs exceed the expected future revenues/benefits related thereto, such excess has been charged as an expense immediately.

Repairs and Maintenance

36. The auditor should scrutinise the repairs and maintenance account to ascertain that new fixed assets and substantial improvements to existing assets have not been included in repairs and maintenance. The auditor should exercise special care particularly in case large amounts charged to the Profit and Loss Account.

Contingencies

37. In respect of product warranties, service contracts, performance warranties, etc., the auditor should examine whether provisions have been made in accordance with Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date*. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements and the assessment based on his past experience.

Taxes on Income

38. The auditor should examine that tax expense or tax saving has been properly computed and disclosed in the financial statements\(^\text{10}\). The tax expense for the period which comprises current tax and deferred tax is to be included in the determination of net profit or loss for the period under audit. In case of companies attracting minimum alternate tax, it has to be ensured that proper provision has been considered in the accounts. The auditor should examine that the deferred taxes have been recognised for all timing differences subject to

\(^{10}\) Attention is drawn to Accounting Standard (AS) 22, *Accounting for Taxes on Income*. 
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consideration of prudence in respect of deferred tax assets as set out in Accounting Standard (AS) 22, *Accounting for Taxes on Income*. If there is a material departure from the provisions of AS 22, the auditor should qualify his report.

39. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether adjustment is required in the financial statements.

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

41. The auditor should obtain from the management, a statement showing the status of pending tax matters. He should examine the statements to assess the adequacy of provisions made in respect of those matters in the context of their current status.

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

42. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. Some of the illustrative procedures specifically applicable in the case of audit of a company are described below. It may be clarified that the following is not an exhaustive list of additional procedures to be carried out in the case of audit of expenses in the case of a company.

(a) The auditor should examine whether the managerial remuneration paid or payable by the company is within the limits laid own under section 198 and Schedule XIII to the Companies Act, 1956. The auditor should also examine whether the remuneration paid or payable to the directors of the company, including any managing or whole-time director, has been determined by the Articles of Association of the company or by a resolution of the company passed in a general meeting. The auditor should also examine whether the remuneration of directors complies with the provisions of section 309 of the Companies Act, 1956. The auditor should further examine whether the
computation of net profit for purposes of managerial remuneration is in accordance with sections 349 and 350 of the Companies Act, 1956.

(b) The auditor should examine whether the contributions, if any, made by the company to charitable and other funds not directly relating to the business of the company or the welfare of its employees comply with the provisions of section 293 of the Companies Act, 1956. According to this section, the board of directors of a public company cannot, except with the consent of the company in general meeting, contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed Rs.50,000 or 5 per cent of the average net profits of the company as determined in accordance with the provisions of section 349 and section 350 during the three financial years immediately preceding, whichever is greater. The auditor should examine whether the Memorandum of Association of the company empowers it to make contributions to charitable or other funds not directly relating to the business of the company or the welfare of its employees. If the objects clause in the Memorandum does not contain such authority, the company has no power to make such contributions.

The auditor should ask the management to prepare a schedule of contributions to various funds covered by section 293 made during the year, giving the names of the institutions to which contributions have been made, the amounts paid and the dates on which the contributions were approved by the board of directors. He should also ask the management to prepare a computation showing the limits of permissible contributions which can be made under this section.

(c) The auditor should examine whether political contributions made by the company are within the limit prescribed in section 293A of the Companies Act, 1956.11 Where the limit laid down under section 293A is adhered to and the facts are properly disclosed, the auditor has no further duty. Where, however, the facts regarding such contributions are not properly disclosed, the auditor should qualify his report and state the facts therein. Where the auditor has genuine doubt regarding the applicability of the Section, he should ensure that the fact is properly disclosed in his audit report.

Where the auditor is satisfied that political contributions have been made in excess of the limit prescribed in section 293A, he should bring this to the attention of the shareholders by qualifying his audit report and making a mention of the excess amount involved, if ascertainable.

The auditor should obtain a certificate from company's board of directors to the effect that all amounts of contributions to political parties or for any political purpose to any person falling under the provisions of section 293A have been brought into the books of account of the company.

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11 Reference may be made in this regard to the Guidance Note on Section 293A of the Companies Act, 1956 and the Auditor.
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the company and that no amounts of such nature other than those so included in the books have been paid/given, directly or indirectly.

(d) The auditor should examine whether the contribution, if any, to the National Defence Fund or any other fund approved by the Central Government for the purpose of national defence complies with the provisions of section 293B of the Companies Act, 1956. This section empowers the board of directors to make such contributions. It may be noted that unlike the contributions to charitable or other funds not directly relating to the business of the company or to the welfare of its employees, contributions to National Defence Fund (or other similar funds) can be made by a company even where the Memorandum of Association of the company does not specifically empower it in this regard. The auditor should examine whether the total amount or amounts contributed by the company to the National Defence Fund (or other similar funds) during the year have been suitably disclosed in the profit and loss account.

(e) In respect of payments to sole-selling agents, the auditor should examine whether the provisions of sections 294, 294A and 294AA have been complied with.

(f) The auditor should examine whether the provisions of section 297 have been complied with in appropriate cases. He should also examine compliance with the terms and conditions, if any, stipulated by the Central Government in its approval under the proviso to sub-section (1) of section 297.

(g) In case any partner or relative of a director of the company, any firm in which such director, or relative of such director, is a partner, any private company of which such director is a director or member, or any director, or manager of such a private company, holds any office or place of profit under the company or under any subsidiary of the company, the auditor should examine whether the provisions of section 314 have been complied with.

(h) The auditor should examine whether any personal expenses have been charged to revenue account.\(^{12}\)

(i) The auditor should examine whether the transaction of purchase of goods and materials and services, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Companies Act, 1956, as aggregating during the year to Rs.50,000\(^{13}\) (Rupees Fifty Thousand) or more in respect of each party, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials and services or the prices at which transaction for similar goods or service have been made with other parties.\(^{13}\)

(j) The auditor should examine whether any undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding as at

\(^{12}\) Reference may be made in this regard to the Statement on the Qualification in Auditor’s Report.

\(^{13}\) This limit has been enhanced to Rs. five lacs by the Companies (Auditor’s) Report Order, 2003.
the last day of financial year concerned, for a period of more than six months from the date they became payable have been reported under MAOCARO, 1988.  

**Examination of Presentation and Disclosure**

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

**Management Representation**

44. The auditor should consider obtaining a management representation on expenses charged to the statement of profit or loss when other sufficient appropriate audit evidence cannot reasonably be expected to exist.  

**Documentation**

45. The auditor should maintain adequate working papers regarding audit of expenses.

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14 Reference may be made in this regard to the Statement on the Companies (Auditor’s Report) Order, 2003.


16 Reference may be made in this regard to Auditing and Assurance Standard (AAS-11) (SA 580), Representation by Management.