

PAPER – 5: ADVANCED ACCOUNTING

PART – I: ANNOUNCEMENTS STATING APPLICABILITY & NON-APPLICABILITY For May, 2020 EXAMINATION

A. Applicable for May, 2020 Examination

I. Amendments in Schedule III (Division I) to the Companies Act, 2013

In exercise of the powers conferred by sub-section (1) of section 467 of the Companies Act, 2013, the Central Government made the following amendments in Division I of the Schedule III with effect from the date of publication of this notification in the Official Gazette:

- (A) under the heading “II Assets”, under sub-heading “Non-current assets”, for the words “Fixed assets”, the words “Property, Plant and Equipment” shall be substituted;
- (B) in the “Notes”, under the heading “General Instructions for preparation of Balance Sheet”, in paragraph 6,-
 - (I) under the heading “B. Reserves and Surplus”, in item (i), in sub- item (c), the word “Reserve” shall be omitted;
 - (II) in clause W., for the words “fixed assets”, the words “Property, Plant and Equipment” shall be substituted.

II. Amendment in AS 11 “The Effects of Changes in Foreign Exchange Rates”

In exercise of the powers conferred by clause (a) of sub-section (1) of section 642 of the Companies Act, 1956, the Central Government, in consultation with National Advisory Committee on Accounting Standards, hereby made the amendment in the Companies (Accounting Standards) Rules, 2006, in the “ANNEXURE”, under the heading “ACCOUNTING STANDARDS” under “AS 11 on The Effects of Changes in Foreign Exchange Rates”, for the paragraph 32, the following paragraph shall be substituted, namely :-

“32. An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. Remittance from a non-integral foreign operation by way of repatriation of accumulated profits does not form part of a disposal unless it constitutes return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down”.

III. Amendments made by MCA in the Companies (Accounting Standards) Rules, 2006

Amendments made by MCA on 30.3.2016 in the Companies (Accounting Standards) Rules, 2006 have been made applicable for May, 2020 examination.

MCA has issued Companies (Accounting Standards) Amendment Rules, 2016 to amend Companies (Accounting Standards) Rules, 2006 by incorporating the references of the Companies Act, 2013, wherever applicable. Also, the Accounting Standard (AS) 2, AS 4, AS 10, AS 13, AS 14, AS 21 and AS 29 as specified in these Rules will substitute the corresponding Accounting Standards with the same number as specified in Companies (Accounting Standards) Rules, 2006.

Following table summarizes the changes made by the Companies (Accounting Standards) Amendment Rules, 2016 vis a vis the Companies (Accounting Standards) Rules, 2006 in the accounting standards relevant for Paper 5:

Name of the standard	Para no.	As per the Companies (Accounting Standards) Rules, 2006	As per the Companies (Accounting Standards) Amendment Rules, 2016	Implication
AS 4	Footnote to AS 4	Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1-4-2004, all paragraphs of this Standard that deal with contingencies (viz. paragraphs 1(a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16) stand withdrawn except to the extent they deal with impairment of assets not covered by	All paragraphs of this Standard that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government. For example, the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful	Footnote has been modified.

		other Indian Accounting Standards. For example, impairment of receivables (commonly referred to as the provision for bad and doubtful debts), would continue to be covered by AS 4.	debts) is governed by this Standard.	
	8.5	There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.	There are events which, although take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. For example, if dividends are declared after the balance sheet date but before the financial statements are approved for issue, the dividends are not recognized as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are	No liability for proposed dividends must be created now. Such proposed dividends are to be disclosed in the notes.

			disclosed in the notes.	
	14	Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.	If an enterprise declares dividends to shareholders after the balance sheet date, the enterprise should not recognize those dividends as a liability at the balance sheet date unless a statute requires otherwise. Such dividends should be disclosed in notes.	No liability for proposed dividends should be created now. Such proposed dividends are to be disclosed in the notes.
AS 14	3(a)	Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.	Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies and includes 'merger'.	Definition of Amalgamation has been made broader by specifically including 'merger'.
	18 and 39	In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Account') which is disclosed as a part of 'miscellaneous	In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Reserve') which is presented as a	Corresponding debit on account of statutory reserve in case of amalgamation in the nature of purchase is termed as 'Amalgamation Adjustment Reserve' and is now to be

		expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.	separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.	presented as a separate line item since there is not sub-heading like 'miscellaneous expenditure' in Schedule III to the Companies Act, 2013
AS 29	35 (An extract)	The amount of a provision should not be discounted to its present value.	The amount of a provision should not be discounted to its present value except in case of decommissioning, restoration and similar liabilities that are recognized as cost of Property, Plant and Equipment. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should	Now discounting of provision for decommissioning, restoration and similar liabilities should be done as per the pre-tax discount rate as mentioned therein.

			be recognized in the statement of profit and loss.	
	73		<u>Transitional Provisions</u> All the existing provisions for decommissioning, restoration and similar liabilities (see paragraph 35) should be discounted prospectively, with the corresponding effect to the related item of property, plant and equipment.	Discounting of above existing provisions and similar liabilities should be prospectively, with the corresponding effect to the related item of property, plant and equipment.

IV. Companies (Share Capital and Debentures) Amendment Rules, 2019 – reg. Debenture Redemption Reserve

In exercise of the powers conferred by sub-sections (1) and (2) of section 469 of the Companies Act, 2013 (18 of 2013), the Central Government made the Companies (Share Capital and Debentures) Amendment Rules, 2019 dated 16th August, 2019 to amend the Companies (Share Capital and Debentures) Rules, 2014. As per the Companies (Share Capital and Debentures) Amendment Rules, under principal rules, in rule 18, for sub-rule (7), the following sub-rule shall be substituted, namely: -

“(7) The company shall comply with the requirements with regard to Debenture Redemption Reserve (DRR) and investment or deposit of sum in respect of debentures maturing during the year ending on the 31st day of March of next year, in accordance with the conditions given below:-

- (a) Debenture Redemption Reserve shall be created out of profits of the company available for payment of dividend;
- (b) the limits with respect to adequacy of Debenture Redemption Reserve and investment or deposits, as the case may be, shall be as under;-
 - (i) Debenture Redemption Reserve is not required for debentures issued by All India Financial Institutions regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures;
 - (ii) For other Financial Institutions within the meaning of clause (72) of section

2 of the Companies Act, 2013, Debenture Redemption Reserve shall be as applicable to Non –Banking Finance Companies registered with Reserve Bank of India.

- (iii) For listed companies (other than All India Financial Institutions and Banking Companies as specified in sub-clause (i)), Debenture Redemption Reserve is not required in the following cases - (A) in case of public issue of debentures – A. for NBFCs registered with Reserve Bank of India under section 45-IA of the RBI Act, 1934 and for Housing Finance Companies registered with National Housing Bank; B. for other listed companies; (B) in case of privately placed debentures, for companies specified in sub-items A and B.
- (iv) for unlisted companies, (other than All India Financial Institutions and Banking Companies as specified in sub-clause (i)) -
 - (A) for NBFCs registered with RBI under section 45-IA of the Reserve Bank of India Act, 1934 and for Housing Finance Companies registered with National Housing Bank, Debenture Redemption Reserve is not required in case of privately placed debentures.
 - (B) for other unlisted companies, the adequacy of Debenture Redemption Reserve shall be ten percent. of the value of the outstanding debentures;
- (v) In case a company is covered in item (A) or item (B) of sub-clause (iii) of clause (b) or item (B) of sub-clause (iv) of clause (b), it shall on or before the 30th day of April in each year, in respect of debentures issued by a company covered in item (A) or item (B) of sub clause (iii) of clause (b) or item (B) of sub-clause (iv) of clause (b), invest or deposit, as the case may be, a sum which shall not be less than fifteen per cent., of the amount of its debentures maturing during the year, ending on the 31st day of March of the next year in any one or more methods of investments or deposits as provided in sub-clause (vi):

Provided that the amount remaining invested or deposited, as the case may be, shall not at any time fall below fifteen percent. of the amount of the debentures maturing during the year ending on 31st day of March of that year.
- (vi) for the purpose of sub-clause (v), the methods of deposits or investments, as the case may be, are as follows:— (A) in deposits with any scheduled bank, free from any charge or lien; (B) in unencumbered securities of the Central Government or any State Government; (C) in unencumbered securities mentioned in sub-clause (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882; (D) in unencumbered bonds issued by any other

company which is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882:

Provided that the amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above.

- (c) in case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non-convertible portion of debenture issue in accordance with this sub-rule.
- (d) the amount credited to Debenture Redemption Reserve shall not be utilized by the company except for the purpose of redemption of debentures."

NOTE: Unit 3 of Chapter 4 on Redemption of Debentures of Intermediate Paper 5 Advanced Accounting Study Material has been revised. The revised unit has been uploaded on the BoS Knowledge Portal of the Institute's website. It is advised to ignore the unit given in July, 2015 Edition (or prior Edition) of the Study Material and to refer the updated unit uploaded on the BoS Knowledge Portal of the Institute's website at the below mentioned link: <https://resource.cdn.icai.org/54231bos43539cp4-u3.pdf>

V. Provisions of the Companies Act, 2013 related with Liquidation of Companies

As per Section 2 (94A) of the Companies Act, 2013, winding up means winding up under this Act. As per section 270, the provision of Part I should apply to the winding up of a company by the Tribunal under this Act.

Circumstances in which Company may be wound up by Tribunal [Section 271]

- (a) The company has resolved that the company be wound up by the Tribunal.
- (b) The company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality
- (c) The Registrar or any other person authorized by the Central Government by notification under this Act can make an application to tribunal. The Tribunal is of the opinion that the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose or the persons concerned in the formation or management of its affairs have been guilty of fraud, misfeasance or misconduct in connection therewith and that it is proper that the company be wound up.
- (d) The company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding 5 consecutive financial years.
- (e) The Tribunal is of the opinion that it is just and equitable that the company should be wound up.

A company may file petition for winding up under section 272 of the Companies Act, 2013. Petition for winding up to Tribunal can be made by the company, any contributory or contributories, the registrar, any person authorized by Central Govt. in that behalf or if case affairs of the company have been conducted in a Fraudulent manner, by the Central Government or a State Government.

Petition by Contributory

A contributory should be entitled to present a petition for the winding up of a company. Shares in respect of which he is a contributory were either originally allotted to him or have been held by him for at least 6 months during the 18 months immediately before the commencement of the winding up and registered in his name or have transferred to him through the death of a former holder.

Petition by Registrar

The Registrar should be entitled to present a petition for winding up under section 271, except on the grounds specified in section 271 (a) or (e). The Registrar should obtain the previous sanction of the Central Government to the presentation of a petition. The Central Government should not accord its sanction unless the company has been given a reasonable opportunity of making representations.

Petition by Company

A petition presented by the company for winding up before the Tribunal should be admitted only if accompanied by a statement of affairs in such form and in such manner as may be prescribed.

A copy of the petition made under this section should also be filed with the Registrar and the Registrar should, without prejudice to any other provisions, submit his views to the Tribunal within 60 days of receipt of such petition.

A company may be wound up voluntarily [Section 304¹],:

- (a) if the company in general meeting passes a resolution requiring the company to be wound up voluntarily as a result of the expiry of the period for its duration, if any, fixed by its articles or on the occurrence of any event in respect of which the articles provide that the company should be dissolved; or
- (b) if the company passes a special resolution that the company be wound up.

Liquidators' Statement of Account

In case of Compulsory wound-up, the Company Liquidator should keep proper books in such manner, as may be prescribed, in which he should cause entries or minutes

¹Applicable until 31 March 2017; with effect from 1 April 2017, Section 59 of the Insolvency and Bankruptcy Code, 2016 is applicable.

to be made of proceedings at meetings and of such other matters as may be prescribed.

Any creditor or contributory may, subject to the control of the Tribunal, inspect any such books, personally or through his agent.

While preparing the liquidator's statement of account, receipts are shown in the following order:

- (a) Amount realized from assets are included in the prescribed order.
- (b) In case of assets specifically pledged in favour of creditors, only the surplus from it, if any, is entered as 'surplus from securities'.
- (c) In case of partly paid up shares, the equity shareholders should be called up to pay necessary amount (not exceeding the amount of uncalled capital) if creditors' claims/claims of preference shareholders can't be satisfied with the available amount. Preference shareholders would be called upon to contribute (not exceeding the amount as yet uncalled on the shares) for paying of creditors.
- (d) Amounts received from calls to contributories made at the time of winding up are shown on the Receipts side.
- (e) Receipts per Trading Account are also included on the Receipts side.
- (f) Payments made to redeem securities and cost of execution and payments per Trading Account are deducted from total receipts.

Payments are made and shown in the following order:

- (a) Legal charges;
- (b) Liquidator's expenses;
- (c) Debenture holders (including interest up to the date of winding up if the company is insolvent and to the date of payment if it is solvent);
- (d) Creditors:
 - (i) Preferential (in actual practice, preferential creditors are paid before debenture holders having a floating charge);
 - (ii) Unsecured creditors;
- (e) Preferential shareholders (Arrears of dividends on cumulative preference shares should be paid up to the date of commencement of winding up); and
- (f) Equity shareholders.

Commencement of Winding Up by Tribunal [Section 357]

Where, before the presentation of a petition for the winding up of a company by the Tribunal, a resolution has been passed by the company for voluntary winding up, the winding up of the company should be deemed to have commenced at the time of the

passing of the resolution, and unless the Tribunal, on proof of fraud or mistake, thinks fit to direct otherwise, all proceedings taken in the voluntary winding up should be deemed to have been validly taken.

In any other case, the winding up of a company by the Tribunal should be deemed to commence at the time of the presentation of the petition for the winding up.

Exclusion of Certain Time in Computing Period of Limitation [Section 358]

Notwithstanding anything in the Limitation Act, 1963, or in any other law for the time being in force, in computing the period of limitation specified for any suit or application in the name and on behalf of a company which is being wound up by the Tribunal, the period from the date of commencement of the winding up of the company to a period of one year immediately following the date of the winding up order should be excluded.

Statement of Affairs

In case of winding up by Tribunal, Section 272(5) of the Companies Act, 2013 provides that a petition presented by the company for winding up before the Tribunal shall be admitted only if accompanied by a statement of affairs in such form and in such manner as may be prescribed.

In accordance with Section 274(1), where a petition for winding up is filed before the Tribunal by any person other than the company, the Tribunal shall, if satisfied that a prima facie case for winding up of the company is made out, by an order direct the company to file its objections along with a statement of its affairs within thirty days of the order in such form and in such manner as may be prescribed. The Tribunal may allow a further period of thirty days in a situation of contingency or special circumstances.

The broad lines on which the Statement of Affairs is prepared are the following —

- (1) Include assets on which there is no fixed charge at the value they are expected to realize. Students should note to include calls in arrear but not uncalled capital.
- (2) Include assets on which there is a fixed charge. The amount expected to be realized would be compared with the amount due to the creditor concerned. Any **surplus** is to be extended to the other column. A **deficit** (the amount owed to the creditor exceeding the amount realizable from the asset) is to be added to unsecured creditors.
- (3) The total of assets in point (1) and any surplus from assets mentioned in point (2) is available for all the creditors (except secured creditors already covered by specifically mortgaged assets).
- (4) From the total assets available, the following should be deducted one by one:-
 - (i) Preferential creditors,

- (ii) Debentures having a floating charge, and
- (iii) Unsecured creditors.

If a minus balance emerges, there would be deficiency as regards creditors, otherwise there would be a surplus.

- (5) The amount of total paid-up capital (giving details of each class of shares) should be added and the figure emerging will be deficiency (or surplus) as regards members.

Note: Statement of affairs should accompany eight lists:

- List A Full particulars of every description of property not specifically pledged and included in any other list are to be set forth in this list.
- List B Assets specifically pledged and creditors fully or partly secured.
- List C Preferential creditors for rates, taxes, salaries, wages and otherwise.
- List D List of debenture holders secured by a floating charge.
- List E Unsecured creditors.
- List F List of preference shareholders.
- List G List of equity shareholders.
- List H Deficiency or surplus account.

Deficiency Account

The official liquidator will specify a date for period (minimum three years) beginning with the date on which information is supplied for preparation of an account to explain the deficiency or surplus. On that date either assets would exceed capital plus liabilities, that is, there would be a reserve or there would be a deficit or debit balance in the Profit and Loss Account. The Deficiency account is divided into two parts:

1. The first part starts with the deficit (on the given date) and contains every item that increases deficiency (or reduces surplus such as losses, dividends etc.).
2. The second part starts with the surplus on the given date and includes all profits.

If the total of the first exceeds that of the second, there would be a deficiency to the extent of the difference, and if the total of the second part exceeds that of the first, there would be a surplus.

Overriding Preferential Payments [Section 326]: In the winding up of a company under this Act, the following debts should be paid in priority to all other debts:

- a. workmen's dues; and
- b. where a secured creditor has realized a secured asset, so much of the debts due to such secured creditor as could not be realized by him or the amount of

the workmen's portion in his security (if payable under the law), whichever is less, pari-passu with the workmen's dues:

Explanation: For the purposes of this section, and section 327 -

- a) **Workmen**, in relation to a company, means the employees of the company, being workmen within the meaning of Section 2 (s) of the Industrial Disputes Act, 1947;
- b) **Workmen's dues**, in relation to a company, means the aggregate of the following sums due from the company to its workmen, namely:
 - (i) All wages or salary including wages payable;
 - (ii) all accrued holiday remuneration becoming payable to any workman
 - (iii) unless the company is being wound up voluntarily merely for the purposes of reconstruction or amalgamation with another company or unless the company has, at the commencement of the winding up, under such a contract with insurers as is mentioned in section 14 of the Workmen's Compensation Act, 1923 (19 of 1923), rights capable of being transferred to and vested in the workmen, all amount due in respect of any compensation or liability for compensation under the said Act in respect of the death or disablement of any workman of the company;
 - (iv) all sums due to any workman from provident fund, pension fund, gratuity fund or any other fund maintained by the company.

The following payment should be made in priority to secured creditors:

- (i) All wages or salary including wages payable;
 - (ii) all accrued holiday remuneration becoming payable to any workman
 - (iii) If the above payments are payable for a period of 2 years preceding the winding up order then the same shall be paid in priority to all other debts (including debts due to secured creditors), within a period of 30 days of sale of assets and shall be subject to such charge over the security of secured creditors.
- c) **Workmen's portion**, in relation to the security of any secured creditor of a company, means the amount which bears to the value of the security the same proportion as the amount of the workmen's dues bears to the aggregate of the amount of workmen's dues and the amount of the debts due to the secured creditors.

Preferential Creditors

In a winding up there should be paid in priority to all other debts subject to the provisions of section 326.

Preferential Creditors are as follows:

- a. **Government Taxes:** All revenues, taxes, cess and rates due from the company to the Central Government or a State Government or to a local authority at the relevant date, and having become due and payable within the twelve months immediately before that date;
- b. **Salary and Wages:** All wages or salary including wages payable for time or piece work and salary earned wholly or in part by way of commission of any employee in respect of services rendered to the company and due for a period not exceeding four months within the 12 months immediately before the relevant date, subject to the condition that the amount payable under this clause to any workman should not exceed such amount as may be notified;
- c. **Holiday Remuneration:** All accrued holiday remuneration becoming payable to any employee, or in the case of his death, to any other person claiming under him, on the termination of his employment before, or by the winding up order, or, as the case may be, the dissolution of the company;
- d. **Contribution under ESI Act:** Unless the company is being wound up voluntarily merely for the purposes of reconstruction or amalgamation with another company, all amount due in respect of contributions payable during the period of twelve months immediately before the relevant date by the company as the employer of persons under the Employees' State Insurance Act, 1948 or any other law for the time being in force;
- e. **Compensation in respect of death or disablement:** Unless the company has, at the commencement of winding up, under such a contract with any insurer as is mentioned in section 14 of the Workmen's Compensation Act, 1923, rights capable of being transferred to and vested in the workmen, all amount due in respect of any compensation or liability for compensation under the said Act in respect of the death or disablement of any employee of the company: Where any compensation under the said Act is a weekly payment, the amount payable under this clause should be taken to be the amount of the lump sum for which such weekly payment could, if redeemable, be redeemed, if the employer has made an application under that Act;
- f. **PF, Pension Fund or Gratuity Fund:** All sums due to any employee from the provident fund, the pension fund, the gratuity fund or any other fund for the welfare of the employees, maintained by the company; and
- g. **Expenses of Investigation:** The expenses of any investigation held in pursuance of sections 213 and 216, in so far as they are payable by the company.

Where any advance payment has been made to any employee of a company on account of wages or salary or accrued holiday remuneration himself by some person for that purpose. The person by whom the money was advanced should have a right of priority in respect of the money so advanced and paid-up to the amount. The sum in respect of which the employee or other person in his right would have been entitled to priority in the winding up has been reduced by reason of the payment having been made.

The debts enumerated in this section should—

- h. rank equally among themselves and be paid in full, unless the assets are insufficient to meet them, in which case they should abate in equal proportions; and
- i. so far as the assets of the company available for payment to general creditors are insufficient to meet them, have priority over the claims of holders of debentures under any floating charge created by the company, and be paid accordingly out of any property comprised in or subject to that charge.

The debts under this section should be discharged forthwith so far as the assets are sufficient to meet them, subject to the retention of such sums as may be necessary for the costs and expenses of the winding up.

In the event of a landlord or other person distraining or having distrained on any goods or effects of the company within three months immediately before the date of a winding up order, the debts to which priority is given under this section should be a first charge on the goods or effects so distrained on or the proceeds of the sale thereof: Provided that, in respect of any money paid under any such charge, the landlord or other person should have the same rights of priority as the person to whom the payment is made. Any remuneration in respect of a period of holiday or of absence from work on medical grounds through sickness or other good cause should be deemed to be wages in respect of services rendered to the company during that period.

Explanations: For the purposes of this section,

- **Accrued Holiday Remuneration includes**, in relation to any person, all sums which, by virtue either of his contract of employment or of any enactment including any order made or direction given thereunder, are payable on account of the remuneration which would, in the ordinary course, have become payable to him in respect of a period of holiday, had his employment with the company continued until he became entitled to be allowed the holiday;
- **Employee** does not include a workman; and
- **Relevant Date** means in the case of a company being wound up by the Tribunal, the date of appointment or first appointment of a provisional liquidator, or if no such appointment was made, the date of the winding up order, unless, in either

case, the company had commenced to be wound up voluntarily before that date under the Insolvency and Bankruptcy Code, 2016.

Effect of Floating Charge [Section 332]

Where a company is being wound up, a floating charge on the undertaking or property of the company created within the 12 months immediately preceding the commencement of the winding up, should be invalid unless it is proved that the company immediately after the creation of the charge was solvent except for the amount of any cash paid to the company at the time of and in consideration for or subsequent to the creation of the charge together with interest on that amount at the rate of 5 per cent per annum or such other rate as may be notified by the Central Government in this behalf.

B List Contributories

- (a) **Persons:** Shareholders who had transferred Partly Paid Shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an amount to pay off such Creditors as existed on the date of transfer of shares. These Transferors are called as B List Contributories.
- (b) **Liability:** Their liability is restricted to the amount not called up when the shares were transferred. They cannot be called upon to pay more than the entire face value of the share. For example, if Shares having Face Value ₹ 100 were paid up ₹ 60, the B List Contributory can be called up to pay a maximum of ₹ 40 only.
- (c) **Conditions:** Liability of B List Contributories will crystallize only (a) when the existing assets available with the liquidator are not sufficient to cover the liabilities; (b) when the existing shareholders fail to pay the amount due on the shares to the Liquidator.

VI Maintenance of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR)

Statutory Liquidity Ratio (SLR)

In exercise of the powers conferred by sub-section (2A) of Section 24 read with Section 51 and Section 56 of the Banking Regulation Act, 1949 (10 of 1949) and in supersession of the notifications DBR.No.Ret.BC.14/12.02.001/2016-17 dated October 13, 2016 BR.NDBR.No.Ret.BC.91/12.02.001/2017-18 dated October 04, 2017, the Reserve Bank hereby specifies that with effect from the dates given below, every Scheduled Commercial Bank (including RRBs), Local Area Bank, Small Finance Bank, Payments Bank, Primary (urban) co-operative bank and State and central co-operative banks shall continue to maintain in India assets (referred to as 'SLR assets') the value of which shall not, at the close of business on any day, be less than:

- (i) 19.25 per cent from January 5, 2019
- (ii) 19.00 per cent from April 13, 2019

- (iii) 18.75 per cent from July 6, 2019
- (iv) 18.50 per cent from October 12, 2019
- (v) 18.25 per cent from January 4, 2020
- (vi) 18.00 per cent from April 11, 2020

of their total net demand and time liabilities in India as on the last Friday of the second preceding fortnight, valued in accordance with the method of valuation specified by the Reserve Bank from time to time.

Cash Reserve Ratio (CRR)

The current Cash Reserve Ratio (CRR) is 4% of their Net Demand and Time Liabilities (NDTL) with effect from the fortnight beginning February 09, 2013 vide circular DBOD.No.Ret.BC.76 /12.01.001/2012-13 dated January 29, 2013. The Local Area Banks shall also maintain CRR at 4.00 per cent of its net demand and time liabilities from the fortnight beginning from February 09, 2013.

VII Sale of Securities held in Held to Maturity (HTM) Category

Accounting treatment

Investments by Primary (Urban) Co-operative Banks (UCBs) if securities acquired by banks with the intention to hold them up to maturity will be classified under HTM category. As per Circular no. RBI/2018-19/205 DCBR.BPD. (PCB) Cir.No.10/16.20.000/2018-19 dated 10th June, 2019, it is reiterated that UCBs are not expected to resort to sale of securities held in HTM category. However, if due to liquidity stress, UCBs are required to sell securities from HTM portfolio, they may do so with the permission of their Board of Directors and rationale for such sale may be clearly recorded. Profit on sale of investments from HTM category shall first be taken to the Profit and Loss account and, thereafter, the amount of such profit shall be appropriated to 'Capital Reserve' from the net profit for the year after statutory appropriations. Loss on sale shall be recognized in the Profit and Loss account in the year of sale.

Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks

As per Circular no. RBI/2018-19/204 DBR.No.BP.BC.46/21.04.141/2018-19 dated 10th June, 2019 (referring to RBI circular DBR No BP.BC.6/21.04.141/2015-16 dated July 1, 2015 advising banks that if the value of sales and transfer of securities to / from HTM category exceeds 5 per cent of the book value of investments held in HTM category at the beginning of the year) banks should disclose the market value of the investments held in the HTM category and indicate the excess of book value over market value for which provision is not made. Apart from transactions that are already exempted from inclusion in the 5 per cent cap, it has been decided that repurchase

of State Development Loans (SDLs) by the concerned state government shall also be exempted.

VIII Relevant Provisions of the Insurance Act [updated as per the Insurance (Amendment) Act, 2015]

The provisions of sections 10 and 11 have been modified vide the Insurance Laws (Amendment) Act, 2015. These amendments have necessitated changes to the IRDA (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations 2002. The significant provisions are as follows:

- (1) Forms for final accounts [Section 11(1)]: Every insurer, on or after the date of the commencement of the Insurance Laws (Amendment) Act, 2015, in respect of insurance business transacted by him and in respect of his shareholders' funds, should, at the expiration of each financial year, prepare with reference to that year, balance sheet, a profit and loss account, a separate account of receipts and payments, a revenue account in accordance with the regulations as may be specified.
- (2) Audit [Section 12]: The balance sheet, profit and loss account, revenue account and profit and loss appropriation account of every insurer, in respect of all insurance business transacted by him, should, unless they are subject to audit under the Companies Act, 2013, be audited annually by an auditor, and the auditor should in the audit of all such accounts have the powers of, exercise the functions vested in, and discharge the duties and be subject to the liabilities and penalties imposed on, auditors of companies by Section 147 of the Companies Act, 2013.
- (3) Register of policies [Section 14(1)]: Every insurer, in respect of all business transacted by him, should maintain— (a) a record of policies, in which should be entered, in respect of every policy issued by the insurer, the name and address of the policyholder, the date when the policy was effected and a record of any transfer, assignment or nomination of which the insurer has notice; (b) a record of claims, every claim made together with the date of the claim, the name and address of the claimant and the date on which the claim was discharged, or, in the case of a claim which is rejected, the date of rejection and the grounds thereof; and (c) a record of policies and claims in accordance with clauses (a) and (b) may be maintained in any such form, including electronic mode, as may be specified by the regulations made under this Act.
- (4) Approved investments (Section 27B(1)): A company carrying on general insurance business must invest its funds only in approved securities listed in this section.

- (5) Payment of commission to authorized agents (Section 40(1)): As per the Insurance (Amendment) Act 2015, no person should, pay or contract to pay any remuneration or reward, whether by way of commission or otherwise for soliciting or procuring insurance business in India to any person except an insurance agent or an intermediary or insurance intermediary in such manner as may be specified by the regulations.
- (6) Limit on expenditure (Sections 40B and 40C): As per the Insurance (Amendment) Act 2015 No insurer should, in respect of insurance business transacted by him in India, spend as expenses of management in any financial year any amount exceeding the amount as may be specified by the regulations made under this Act and every insurer transacting insurance business in India should furnish to the Authority, the details of expenses of management in such manner and form as may be specified by the regulations made under this Act."
- (7) Sufficiency of assets [Section 64VA(1)]: Every insurer and re-insurer should at all times maintain an excess of value of assets over the amount of liabilities of, not less than fifty per cent. of the amount of minimum capital as stated under section 6 and arrived at in the manner specified by the regulations.
- (8) Segregation of Policyholders' and Shareholders' Funds by the insurers carrying on General Insurance, Health Insurance and Reinsurance business: Section 11 (2) of the Insurance Laws (Amendment) Act, 2015 mandates that every insurer shall keep separate funds of shareholders and policyholders.
- (9) Unearned Premium Reserve (UPR): A Reserve for Unearned Premium shall be created as the amount representing that part of the premium written which is attributable to, and is to be allocated to the succeeding accounting periods. Such Reserves shall be computed as under:
 - a) Marine Hull: 100 percent of Net Written Premium during the preceding twelve months;
 - b) Other Segments: Insurers have an option to create UPR either at 50 percent of Net Written Premium of preceding twelve months or on the basis of 1/365th method on the unexpired period of the respective policies.

The insurers can follow either percentage or 1/365th method for computation of UPR of the other segments. However, Insurers shall follow the method of provisioning of UPR in a consistent manner. Any change in the method of provisioning can be done only with the prior written approval of the Authority.
- 10. Recoupment of the Deficit: Every Insurer shall ensure that the policyholders' fund is fully supported by the policyholders' investments shown in Schedule-SA. Therefore, any deficit/shortfall in policyholders' investments arising out of the loss in the Revenue Account or otherwise shall be recouped by transfer of securities from the shareholders' investments to the policyholders' investments

on a half yearly basis. The valuation of such securities shall be in accordance with the valuation norms as specified in the IRDA (Preparation of Financial Statements and Auditors' Report) Regulations, 2002.

11. Investment made out of the policyholders' funds: Investment made out of the policyholders' funds shall be shown in a separate schedule i.e., 8 A. The format of the same is given as below:

Annexure

SCHEDULE- 8A

INVESTMENTS-POLICYHOLDERS

Particulars	Current Year	Previous Year
	('000)	('000)
LONG TERM INVESTMENTS		
1. Government securities and Government guaranteed bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares - i) Equity; ii) Preference (b) Mutual Funds (c) Debentures/ Bonds (d) Investment Property-Real Estate (e) Other Securities (to be specified)		
4. Investments in Infrastructure and Housing		
Sub-Total		
SHORT TERM INVESTMENTS		
1. Government securities and Government guaranteed bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares- i) Equity ii) Preference (b) Mutual Funds (c) Debentures/ Bonds (d) Other Securities (to be specified)		
4. Investments in Infrastructure and Housing		
Sub-Total		
Total		

NOTE: Chapters 2, 4, 5 and 6 of the Intermediate Paper 5 Advanced Accounting Study Material have been revised in line with the Companies (Accounting Standards) Amendment Rules, Banking and IRDA Regulations. These revised chapters have been uploaded on the BoS Knowledge Portal of the Institute's website. The students of Intermediate level (old course) who have either July, 2015 Edition or prior Edition of the Study Material are required to ignore these chapters given in that material and are advised to read the updated chapters uploaded on the BoS Knowledge Portal of the Institute's website at the below mentioned link: https://www.icai.org/post.html?post_id=12433

B. Not applicable for May, 2020 examination

Non-Applicability of Ind AS for May, 2020 Examination

The Ministry of Corporate Affairs has notified Companies (Indian Accounting Standards) Rules, 2015 on 16th February, 2015, for compliance by certain class of companies. These Ind AS are not applicable for May, 2020 Examination.

PART – II : QUESTIONS AND ANSWERS

QUESTIONS

Dissolution of partnership firm

1. Ram, Wazir and Adil give you the following Balance Sheet as on 31st March, 2019:

Liabilities	₹	Assets	₹
Ram's Loan	15,000	Plant and Machinery at cost	30,000
Capital Accounts:		Fixtures and Fittings	2,000
Ram 30,000		Stock	10,400
Wazir 10,000		Debtors 18,400	
Adil <u>2,000</u>	42,000	Less: Provision <u>(400)</u>	18,000
Sundry Creditors	17,800	Joint Life Policy	15,000
Loan on Hypothecation of		Patents and Trademarks	10,000
Stock	6,200	Cash at Bank	8,000
Joint Life Policy Reserve	12,400		
	93,400		93,400

The partners shared profits and losses in the ratio of Ram 4/9, Wazir 2/9 and Adil 1/3. Firm was dissolved on 31st March, 2019 and you are given the following information:

- (a) Adil had taken a loan from insurers for ₹ 5,000 on the security of Joint Life Policy.

The policy was surrendered and Insurers paid a sum of ₹ 10,200 after deducting ₹ 5,000 for Adil's loan and ₹ 300 as interest thereon.

- (b) One of the creditors took some of the patents whose book value was ₹ 6,000 at a valuation of ₹ 4,500. The balance to that creditor was paid in cash.
- (c) The firm had previously purchased some shares in a joint stock company and had written them off on finding them useless. The shares were now found to be worth ₹ 3,000 and the loan creditor agreed to accept the shares at this value.
- (d) The remaining assets realized the following amount: ₹
- | | |
|-----------------------|-------------------------|
| Plant and Machinery | 17,000 |
| Fixtures and Fittings | 1,000 |
| Stock | 9,000 |
| Debtors | 16,500 |
| Patents | 50% of their book value |
- (e) The liabilities were paid and a total discount of ₹ 500 was allowed by the creditors.
- (f) The expenses of realization amounted to ₹ 2,300.

You are required to prepare the Realization Account, Bank Account and Partners' Capital Accounts in columnar form. Also provide necessary working notes in your answer.

Conversion of Partnership firms into a company

2. The following is the Balance Sheet of M/s. Pratham and Kaushal as on 31st March, 2019:

Liabilities	₹	Assets	₹
Capital Accounts:		Machinery	54,000
Pratham	50,000	Furniture	5,000
Kaushal	30,000	Investment (Non-trading)	50,000
Reserves	20,000	Stock	20,000
Loan Account of Kaushal	15,000	Debtors	21,000
Creditors	40,000	Cash	5,000
	1,55,000		1,55,000

It was agreed that Mr. Rohan is to be admitted for a fourth share in the future profits from 1st April, 2019. He is required to contribute cash towards goodwill and ₹ 15,000 towards capital.

The following further information is furnished:

- (a) Pratham & Kaushal share the profits in the ratio 3 : 2.
- (b) Pratham was receiving salary of ₹ 750 p.m. from the very inception of the firm in 2012 in addition to share of profit.

- (c) The future profit ratio between Pratham, Kaushal & Rohan will be 2:1:1. Pratham will not get any salary after the admission of Rohan.
- (d) It was agreed that the value of goodwill of the firm shall be determined on the basis of 3 years' purchase of the average profits from business of the last 5 years. The particulars of the profits are as under:

Year ended	Profit/(Loss)
31 st March, 2015	25,000
31 st March, 2016	12,500
31 st March, 2017	(2,500)
31 st March, 2018	35,000
31 st March, 2019	30,000

The above Profits and Losses are after charging the Salary of Pratham. The Profit of the year ended 31st March, 2015 included an extraneous profit of ₹ 40,000 and the loss for the year ended 31st March, 2017 was on account of loss by strike to the extent of ₹ 20,000.

- (e) The cash trading profit for the year ended 31st March, 2020 was ₹ 50,000 before depreciation.
- (f) The partners had drawn each ₹ 1,000 p.m. as drawings.
- (g) The value of other assets and liabilities as on 31st March, 2020 were as under:

	₹
Machinery (before depreciation)	60,000
Furniture (before depreciation)	10,000
Investment	50,000
Stock	15,000
Debtors	30,000
Creditors	20,000

- (h) Provide depreciation @ 10% on Machinery and @ 5% on Furniture on the Closing Balance and interest is accumulated @ 6% on Kaushal's loan. The loan alongwith interest would be repaid within next 12 months.
- (i) Investments (non-trading) are held from inception of the firm and interest is received @ 10% p.a.
- (j) The partners applied for conversion of the firm into Karma Ltd., a Private Limited Company. Certificate was received on 1st April, 2020. They decided to convert Capital accounts of the partners into share capital in the ratio of 2:1:1 on the basis of

a total Capital as on 31st March, 2020. If necessary, partners have to subscribe to fresh capital or withdraw.

Prepare the Profit and Loss Account of the firm for the year ended 31st March, 2020 and the Balance Sheet of the Company on 1st April, 2020.

Sale of Partnership firm to a Company

3. Mohit, Neel and Om were Partners sharing Profits and Losses in the ratio of 5:3:2 respectively. The Trial Balance of the Firm on 31st March, 2019 was the following:

Particulars	₹	₹
Machinery at Cost	2,00,000	
Inventory	1,37,400	
Trade receivables	1,24,000	
Trade payables		1,69,400
Capital A/cs:		
Mohit		1,36,000
Neel		90,000
Om		46,000
Drawing A/cs:		
Mohit	50,000	
Neel	46,000	
Om	34,000	
Depreciation on Machinery		80,000
Profit for the year ended 31 st March		2,48,600
Cash at Bank	<u>1,78,600</u>	<u> </u>
	7,70,000	7,70,000

Interest on Capital Accounts at 10% p.a. on the amount standing to the credit of Partners' Capital Account at the beginning of the year, was not provided before preparing the above Trial Balance. On the above date, they formed a MNO Private Limited Company with an Authorized Share Capital of 2,00,000 shares of ₹ 10 each to be divided in different classes to take over the business of Partnership firm.

You are provided the following information:

1. Machinery is to be transferred at ₹ 1,40,000.
2. Shares in the Company are to be issued to the partners, at par, in such numbers, and in such classes as will give the partners, by reason of their shareholdings alone, the

same rights as regards interest on capital and the sharing of profit and losses as they had in the partnership.

3. Before transferring the business, the partners wish to draw from the partnership profits to such an extent that the bank balance is reduced to ₹ 1,00,000. For this purpose, sufficient profits of the year are to be retained in profit-sharing ratio.
4. Assets and liabilities except Machinery and Bank, are to be transferred at their book value as on the above date.

You are required to prepare:

- (a) Statement showing the workings of the Number of Shares of each class to be issued by the company, to each partner.
- (b) Capital Accounts showing all adjustments required to dissolve the Partnership.
- (c) Balance Sheet of the Company immediately after acquiring the business of the Partnership and Issuing of Shares.

Limited Liability Partnerships

4. Differentiate on ordinary partnership firm with an LLP (Limited Liability Partnership) in respect of the following:
 - (1) Applicable Law
 - (2) Number of Partners
 - (3) Ownership of Assets
 - (4) Liability of Partners/Members

Accounting for ESOPs

5. On 1st April, 2019, a company offered 100 shares to each of its 400 employees at ₹ 25 per share. The employees are given a month to accept the shares. The shares issued under the plan shall be subject to lock-in to transfer for three years from the grant date i.e. 30th April 2019. The market price of shares of the company on the grant date is ₹ 30 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at ₹ 28 per share.

Up to 30th April, 2019, 50% of employees accepted the offer and paid ₹ 25 per share purchased. Nominal value of each share is ₹ 10. You are required to record the issue of shares in the books of the company under the aforesaid plan.

Buy Back of Securities

6. The following was the Balance Sheet of C Ltd. as on 31st March ,2019:

Equity & Liabilities	₹ Lakhs	Assets	₹ Lakhs
Share Capital:		Fixed Assets	14,000

Equity shares of ₹ 10 each Fully Paid Up	8,000	Investments	2,350
10% Redeemable Pref. Shares of ₹ 10 each Fully Paid Up	2,500	Cash at Bank	2,300
Reserves & Surplus		Other Current Assets	8,250
Capital Redemption Reserve	1,000		
Securities Premium	800		
General Reserve	6,000		
Profit & Loss Account	300		
Secured Loans:			
9% Debentures	5,000		
Current Liabilities:			
Trade payables	2,300		
Sundry Provisions	<u>1,000</u>		
	<u>26,900</u>		<u>26,900</u>

On 1st April, 2019 the Company redeemed all its Preference Shares at a Premium of 10% and bought back 10% of its Equity Shares at ₹ 20 per Share. In order to make cash available, the Company sold all the Investments for ₹ 2,500 lakhs.

You are required to pass journal entries for the above and prepare the Company's Balance sheet immediately after buyback of equity shares and redemption of preference shares .

Redemption of Debentures

7. The following balances appeared in the books of Lakshya Ltd. as on 1-4-20X1:

- (i) 10 % Debentures ₹ 37,50,000
- (ii) Balance of DRR ₹ 1,25,000
- (iii) DRR Investment 5,62,500 represented by 10% ₹ 5,625 Secured Bonds of the Government of India of ₹ 100 each.

Annual contribution to the DRR was made on 31st March every year. On 31-3-20X2, balance at bank was ₹ 37,50,000 before receipt of interest. Interest on Debentures had already been paid. The investment were realised at par for redemption of debentures at a premium of 10% on the above date.

Lakshya Ltd. is an unlisted company (other than AIFI, Banking company, NBFC and HFC). You are required to prepare Debenture Redemption Reserve Account, Debenture Redemption Reserve Investment Account and Bank Account in the books of Lakshya Ltd. for the year ended 31st March, 20X2.

Underwriting of Shares

8. X Ltd. issued 1,20,000 Equity Shares which were underwritten as follows:

A & Co	72,000 Equity Shares
B & Co.	30,000 Equity Shares
C & Co.	18,000 Equity Shares

The above mentioned underwriters made applications for 'firm' underwritings as follows:

A & Co	9,600 Equity Shares
B & Co	12,000 Equity Shares
C & Co.	3,600 Equity Shares

The total applications excluding 'firm' underwriting, but including marked applications were for 60,000 Equity Shares.

The marked Applications were as under:

A & Co	12,000 Equity Shares
B & Co.	15,000 Equity Shares
C & Co.	6,000 Equity Shares

The underwriting contracts provide that underwriters be given credit for 'firm' applications and that credit for unmarked applications be given in proportion to the shares underwritten. You are required to show the allocation of liability. Workings will be considered as a part of your answer.

Amalgamation of Companies

9. P Ltd. and Q Ltd. agreed to amalgamate and form a new company called PQ Ltd. The summarized balance sheets of both the companies on the date of amalgamation stood as below:

Liabilities	P Ltd. ₹	Q Ltd. ₹	Assets	P Ltd. ₹	Q Ltd. ₹
Equity Shares (₹ 100 each)	8,20,000	3,20,000	Land & Building	4,50,000	3,40,000
9% Pref. Shares (₹ 100 each)	3,80,000	2,80,000	Furniture & Fittings	1,00,000	50,000
8% Debentures	2,00,000	1,00,000	Plant & Machinery	6,20,000	4,50,000
General Reserve	1,50,000	50,000	Trade receivables	3,25,000	1,50,000
Profit & Loss a/c	3,52,000	2,05,000	Inventory	2,33,000	1,05,000
Unsecured Loan	-	1,75,000	Cash at bank	2,08,000	1,75,000

Trade payables	<u>88,000</u>	<u>1,60,000</u>	Cash in hand	<u>54,000</u>	<u>20,000</u>
	<u>19,90,000</u>	<u>12,90,000</u>		<u>19,90,000</u>	<u>12,90,000</u>

PQ Ltd. took over the assets and liabilities of both the companies at book value after creating provision @ 5% on inventory and trade receivables respectively and depreciating Furniture & Fittings by @ 10%, Plant and Machinery by @ 10%. The trade receivables of P Ltd. include ₹ 25,000 due from Q Ltd.

PQ Ltd. will issue:

- (i) 5 Preference shares of ₹ 20 each @ ₹ 18 paid up at a premium of ₹ 4 per share for each pref. share held in both the companies.
- (ii) 6 Equity shares of ₹ 20 each @ ₹ 18 paid up a premium of ₹ 4 per share for each equity share held in both the companies.
- (iii) 6% Debentures to discharge the 8% debentures of both the companies.
- (iv) 20,000 new equity shares of ₹ 20 each for cash @ ₹ 18 paid up at a premium of ₹ 4 per share.

PQ Ltd. will pay cash to equity shareholders of both the companies in order to adjust their rights as per the intrinsic value of the shares of both the companies.

You are required to prepare ledger accounts in the books of P Ltd. and Q Ltd. to close their books.

Internal Reconstruction of a Company

10. The following is the Balance Sheet of Star Ltd. as on 31st March, 2019:

	₹
A. Equity & Liabilities	
1. Shareholders' Fund:	
(a) Share Capital:	
9,000 7% Preference Shares of ₹ 100 each fully paid	9,00,000
10,000 Equity Shares of ₹ 100 each fully paid	10,00,000
(b) Reserve & Surplus:	
Profit & Loss Account	(2,00,000)
2. Non-current liabilities:	
"A" 6% Debentures (Secured on Bombay Works)	3,00,000
"B" 6% Debentures (Secured on Chennai Works)	3,50,000
3. Current Liabilities and Provisions:	
(a) Workmen's Compensation Fund:	

	Bombay Works	10,000
	Chennai Works	5,000
(b)	Trade Payables	<u>1,25,000</u>
	Total	<u>24,90,000</u>
B. Assets:		
Non- current Assets:		
1. Property, Plant & Equipment:		
	Bombay Works	9,50,000
	Chennai Works	7,75,000
2. Investment:		
	Investments for Workman's Compensation Fund	15,000
3. Current Assets:		
(a)	Inventories	4,50,000
(b)	Trade Receivables	2,50,000
(c)	Cash at Bank	<u>50,000</u>
		<u>24,90,000</u>

A reconstruction scheme was prepared and duly approved. The salient features of the scheme were as follows:

- (i) Paid up value of 7% Preference Share to be reduced to ₹ 80, but the rate of dividend being raised to 9%.
- (ii) Paid up value of Equity Shares to be reduced to ₹ 10.
- (iii) The directors to refund ₹ 50,000 of the fees previously received by them.
- (iv) Debenture holders forego their interest of ₹ 26,000 which is included among the trade payables.
- (v) The preference shareholders agreed to waive their claims for preference share dividend, which is in arrears for the last three years.
- (vi) "B" 6% Debenture holders agreed to take over the Chennai Works at ₹ 4,25,000 and to accept an allotment of 1,500 equity shares of ₹ 10 each at par, and upon their forming a company called Zia Ltd. (to take over the Chennai Works) they allotted 9,000 equity shares of ₹ 10 each fully paid at par to Star Ltd.
- (vii) The Chennai Worksmen's compensation fund disclosed that there were actual liabilities of ₹ 1,000 only. As a consequence, the investments of the fund were realized to the extent of the balance. Entire investments were sold at a profit of 10% on book value and the proceeds were utilized for part payment of the creditors.

- (viii) Inventory was to be written off by ₹ 1,90,000 and a provision for doubtful debts is to be made to the extent of ₹ 20,000.
- (ix) Chennai works completely written off.
- (x) Any balance of the Capital Reduction Account is to be applied as two-third to write off the value of Bombay Works and one-third to Capital Reserve.

Pass necessary Journal Entries in the books of Star Ltd. after the scheme has been carried into effect.

Liquidation of Company

11. Alpha Ltd. is under the process of liquidation. Liquidator is entitled to receive remuneration at 2% on the assets realized, 3% on the amount distributed to Preferential Creditors and 3% on the payment made to Unsecured Creditors. The assets were realized for ₹ 37,50,000 against which payment was made as follows:

Liquidation Expenses	₹ 37,500
Secured Creditors	₹ 15,00,000
Preferential Creditors	₹ 1,12,500

The amount due to Unsecured Creditors was ₹ 22,50,000. You are asked to calculate the total Remuneration payable to Liquidator.

Calculation shall be made to the nearest multiple of a rupee.

Financial Statements of Insurance Companies

12. Prepare Revenue Account of M/s Jagan Insurance Co. engaged in marine insurance business for the year ended 31st March, 2019:

	Particulars	Direct Business (₹)	Re-insurance (₹)
I.	Premium		
	Received	3,60,000	38,000
	Receivable - 1 st April, 2018	10,000	1,600
	- 31 st March, 2019	16,000	1,800
	Premium Paid	-	24,000
	Premium Payable - 1 st April, 2018	-	1,000
	- 31 st March, 2019	-	2,200
II.	Claims		
	Paid	1,54,000	14,000
	Payable - 1 st April, 2018	78,000	1,500

	- 31 st March, 2019	16,000	4,200
	Received	-	17,000
	Receivable - 1 st April, 2018	-	1,400
	- 31 st March, 2019	-	1,900
III.	Commission		
	On insurance accepted	96,000	5,600
	On insurance ceded	-	8,000

Details of Other Expenses & Income is as below:

	₹
Establishment Expenses	30,000
Rent, rate & taxes	14,000
Printing & Stationery	1,800
Income from Dividend	18,000
Legal Expenses (Inclusive of ₹ 1,200 in connection with settlement of claims)	2,000

Balance of fund as on 1st April, 2018 was ₹ 3,00,000. Fund required to be maintained at ₹ 3,50,000 on 31.3.2019.

Financial Statements of Banking Companies

13. Anmol Bank Ltd. has a balance of ₹ 40 crores in "Rebate on bills discounted" account as on 31st March, 2018. The Bank provides you the following information:

- During the financial year ending 31st March, 2019 Anmol Bank Ltd. discounted bills of exchange of ₹ 5,000 crores charging interest @ 14% and the average period of discount being 146 days.
- Bills of exchange of ₹ 500 crores were due for realization from the acceptors/customers after 31st March, 2019. The average period of outstanding after 31st March, 2019 being 73 days. These bills of exchange of ₹ 500 crores were discounted charging interest @ 14% p.a.

You are requested to pass necessary Journal Entries in the books of Anmol Bank Ltd. for the above transactions.

Departmental Accounts

14. (a) How will you allocate the following expenses among different departments:

- Rent, rates and taxes, repairs and maintenance, insurance of building;
- Maintenance of capital assets

- (iii) PF/ESI contributions
 - (iv) Carriage inward/ Discount received
 - (v) Lighting and Heating expenses
- (b) There is transfer/sale among the three departments as below:
- Department X sells goods to Department Y at a profit of 25% on cost and to Department Z at 20% profit on cost.
- Department Y sells goods to X and Z at a profit of 15% and 20% on sales respectively.
- Department Z charges 20% and 25% profit on cost to Departments X and Y respectively.
- Department Managers are entitled to 10% commission on net profit subject to unrealised profit on departmental sales being eliminated.
- Departmental profits after charging Managers' commission, but before adjustment of unrealised profit are as under:

	₹
Department X	1,80,000
Department Y	1,35,000
Department Z	90,000

Stocks lying at different Departments at the end of the year are as under:

	Dept. X	Dept. Y	Dept. Z
Transfer from Department X	-	75,000	57,000
Transfer from Department Y	70,000	-	60,000
Transfer from Department Z	30,000	25,000	-

Find out the correct departmental profits after charging Managers' commission.

Branch Accounting

15. On 31st March, 2019 Chennai Branch submits the following Trial Balance to its Head Office at Lucknow:

Debit Balances	₹ in lacs
Furniture and Equipment	18
Depreciation on furniture	2
Salaries	25
Rent	10
Advertising	6

Telephone, Postage and Stationery	3
Sundry Office Expenses	1
Stock on 1st April, 2018	60
Goods Received from Head Office	288
Debtors	20
Cash at bank and in hand	8
Carriage Inwards	<u>7</u>
	<u>448</u>
Credit Balances	
Outstanding Expenses	3
Goods Returned to Head Office	5
Sales	360
Head Office	<u>80</u>
	<u>448</u>

Additional Information:

Stock on 31st March, 2019 was valued at ₹ 62 lacs. On 29th March, 2019 the Head Office dispatched goods costing ₹ 10 lacs to its branch. Branch did not receive these goods before 1st April, 2019. Hence, the figure of goods received from Head Office does not include these goods. Also the head office has charged the branch ₹ 1 lac for centralized services for which the branch has not passed the entry.

You are required to : (i) pass Journal Entries in the books of the Branch to make the necessary adjustments and (ii) prepare Final Accounts of the Branch including Balance Sheet.

Framework for Preparation and Presentation of Financial Statements

16. A Ltd. has entered into a binding agreement with Gamma Ltd. to buy a custom-made machine ₹ 1,00,000. At the end of 20X1-X2, before delivery of the machine, A Ltd. had to change its method of production. The new method will not require the machine ordered and it will be scrapped after delivery. The expected scrap value is nil.

You are required to advise the accounting treatment and give necessary journal entry in the year 20X1-X2.

Problems based on Accounting Standards**AS 4 Contingencies and Events occurring after the Balance Sheet Date**

17. (a) With reference to AS 4 "Contingencies and events occurring after the balance sheet date", state whether the following events will be treated as contingencies, adjusting events or non-adjusting events occurring after balance sheet date in case of a company which follows April to March as its financial year.
- (i) A major fire has damaged the assets in a factory on 5th April, 5 days after the

year end. However, the assets are fully insured and the books have not been approved by the Directors.

- (ii) A suit against the company's advertisement was filed by a party on 10th April, 10 days after the year end claiming damages of ₹ 20 lakhs.

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

- (b) Explain whether the following will constitute a change in accounting policy or not as per AS 5.
 - (i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.
 - (ii) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organization. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organization.

AS 11 The Effects of Changes in Foreign Exchange Rates

18. (a) (i) AXE Limited purchased fixed assets costing \$ 5,00,000 on 1st Jan. 2018 from an American company M/s M&M Limited. The amount was payable after 6 months. The company entered into a forward contract on 1st January 2018 for five months @ ₹ 62.50 per dollar. The exchange rate per dollar was as follows :
- | | |
|----------------------------------|--------------------|
| On 1 st January, 2018 | ₹ 60.75 per dollar |
| On 31 st March, 2018 | ₹ 63.00 per dollar |
- You are required to state how the profit or loss on forward contract would be recognized in the books of AXE Limited for the year ending 2017-18, as per the provisions of AS 11.
- (ii) Assets and liabilities and income and expenditure items in respect of integral foreign operations are translated into Indian rupees at the prevailing rate of exchange at the end of the year. The resultant exchange differences in the case of profit, is carried to other Liabilities Account and the Loss, if any, is charged to revenue. You are required to comment in line with AS 11.

AS 12 Accounting for Government Grants

- (b) How would you treat the following in the accounts in accordance with AS 12 'Government Grants'?
 - (i) ₹ 35 Lakhs received from the Local Authority for providing Medical facilities to the employees.
 - (ii) ₹ 100 Lakhs received as Subsidy from the Central Government for setting up a

unit in a notified backward area.

- (iii) ₹ 10 Lakhs Grant received from the Central Government on installation of anti-pollution equipment.

AS 16 Borrowing Costs

19. (a) Govind Ltd. issued 12% secured debentures of ₹ 100 Lakhs on 01.04.2018, to be utilized as under:

Particulars	Amount (₹ in lakhs)
Construction of factory building	40
Purchase of Machinery	35
Working Capital	25

In March 2019, construction of the factory building was completed and machinery was installed and ready for its intended use. Total interest on debentures for the financial year ended 31.03.2019 was ₹ 12,00,000. During the year 2018-19, the company had invested idle fund out of money raised from debentures in banks' fixed deposit and had earned an interest of ₹ 3,00,000.

You are required to show the treatment of interest under Accounting Standard 16 and also explain nature of assets.

AS 19 Leases

- (b) ABC Ltd. took a machine on lease from XYZ Ltd., the fair value being ₹ 10,00,000. The economic life of the machine as well as the lease term is 4 years. At the end of each year, ABC Ltd. pays ₹ 3,50,000. The lessee has guaranteed a residual value of ₹ 50,000 on expiry of the lease to the lessor. However, XYZ Ltd. estimates that the residual value of the machinery will be ₹ 35,000 only. The implicit rate of return is 16% and PV factors at 16% for year 1, year 2, year 3 and year 4 are 0.8621, 0.7432, 0.6407 and 0.5523 respectively. You are required to calculate the value of machinery to be considered by ABC Ltd. and the finance charges for each year.

AS 20 Earnings per Share

- (c) From the following information, you are required to compute Basic and Diluted Earnings Per Share (EPS) of M/s. XYZ Limited for the year ended 31st March, 2019 :

Net Profit for the year after tax: ₹ 75,00,000

Number of Equity Shares of ₹ 10 each outstanding: ₹ 10,00,000

1,00,000, 8% Convertible Debentures of ₹ 100 each were issued by the Company at the beginning of the year. 1,10,000 Equity Shares were supposed to be issued on conversion. Consider rate of Income Tax as 30%.

AS 26 Intangible Assets

20. (a) A company acquired patent right for ₹ 1200 lakhs. The product life cycle has been estimated to be 5 years and the amortization was decided in the ratio of estimated future cash flows which are as under:

Year	1	2	3	4	5
Estimated future cash flows (₹ in lakhs)	600	600	600	300	300

After 3rd year, it was ascertained that the patent would have an estimated balance future life of 3 years and the estimated cash flow after 5th year is expected to be ₹ 150 lakhs. You are required to determine the amortization pattern under Accounting Standard 26.

AS 29 Provisions, Contingent Liabilities and Contingent Assets

- (b) With reference to AS 29, how would you deal with the following in the annual accounts of the company at the Balance Sheet dates:
- An organization operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten percent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.
 - During 2018-19 Ace Ltd. gives a guarantee of certain borrowings of Brew Ltd., whose financial condition at that time is sound. During 2019-20, the financial condition of Brew Ltd. deteriorates and at 31st Dec. 2019 it goes into Liquidation. (Balance Sheet date 31-3-19)

SUGGESTED ANSWERS/HINTS**1. Realisation Account**

	₹		₹
To Plant and machinery	30,000	By Provision for doubtful debts	400
To Fixtures and fittings	2,000	By Loan on hypothecation of stock (W.N.3)	3,000
To Stock	10,400	By Creditors (W.N.2)	500
To Debtors	18,400	By Joint Life Policy A/c (W.N.4)	12,900

To Patents and Trademarks (W.N.5)	5,500	By Bank		
To Bank	2,300	Plant and machinery	17,000	
		Fixtures and fittings	1,000	
		Stock	9,000	
		Debtors	16,500	
		Patents and Trademarks	<u>2,000</u>	45,500
		By Partners' Capital Accounts		
		Ram	2,800	
		Wazir	1,400	
		Adil	<u>2,100</u>	<u>6,300</u>
	<u>68,600</u>			<u>68,600</u>

Bank Account

	₹		₹
To Balance b/d	8,000	By Adil's Capital A/c- drawings	5,300
To Joint Life Policy	15,500	By Loan on hypothecation of stock	3,200
To Realisation A/c	45,500		
To Adil's Capital A/c	5,400	By Creditors	12,800
		By Realisation A/c (expenses)	2,300
		By Ram's Loan A/c	15,000
		By Ram's Capital A/c	27,200
		By Wazir's Capital A/c	<u>8,600</u>
	<u>74,400</u>		<u>74,400</u>

Partners' Capital Accounts

	Ram	Wazir	Adil		Ram	Wazir	Adil
	₹	₹	₹		₹	₹	₹
To Bank			5,300	By Balance b/d	30,000	10,000	
To Realisation A/c	2,800	1,400	2,100				2,000
To Bank (Bal. Fig.)	<u>27,200</u>	<u>8,600</u>	<u>—</u>	By Bank A/c (bal.fig.)	<u>—</u>	<u>—</u>	<u>5,400</u>
	<u>30,000</u>	<u>10,000</u>	<u>7,400</u>		<u>30,000</u>	<u>10,000</u>	<u>7,400</u>

Working Notes:1. **Ram's Loan Account**

	₹		₹
To Bank A/c	<u>15,000</u>	By Balance b/d	<u>15,000</u>
	<u>15,000</u>		<u>15,000</u>

2. **Sundry Creditors Account**

	₹		₹
To Patents and Trademarks A/c	4,500	By Balance b/d	17,800
To Realisation A/c	500		
To Bank A/c	<u>12,800</u>		
	<u>17,800</u>		<u>17,800</u>

3. **Loan on Hypothecation of Stock Account**

	₹		₹
To Realisation A/c	3,000	By Balance b/d	6,200
To Bank A/c	<u>3,200</u>		
	<u>6,200</u>		<u>6,200</u>

4. **Joint Life Policy Account**

	₹		₹
To Balance b/d	15,000	By Joint Life Policy Reserve A/c	12,400
To Realisation A/c	<u>12,900</u>	By Bank A/c (10,200 + 5,300)	<u>15,500</u>
	<u>27,900</u>		<u>27,900</u>

5. **Patents and Trademarks Account**

	₹		₹
To Balance b/d	10,000	By Creditors A/c	4,500
		By Realisation A/c	1,500
		By Realisation A/c (bal.fig.)	<u>4,000*</u>
	<u>10,000</u>		<u>10,000</u>

2.

M/s Pratham, Kaushal and Rohan

Profit and Loss Account for the year ending on 31st March, 2020

	₹		₹
To Depreciation on Machinery	6,000	By Trading Profit	50,000
To Depreciation on furniture	500	By Interest on Investment	5,000
To Interest on Kaushal's loan	900		
To Net Profit to :			
Pratham's Capital A/c	23,800		
Kaushal's Capital A/c	11,900		
Rohan's Capital A/c	<u>11,900</u>		
	47,600		
	55,000		55,000

Balance Sheet of the Karma Pvt. Ltd. as on 1st April, 2020

	Notes No.	₹
I Equity and Liabilities		
Shareholders' funds		
Share capital		1,41,600
Current liabilities		
Short term borrowings	1	15,900
Trade payables		<u>20,000</u>
Total		<u>1,77,500</u>
II Assets		
Non-current assets		
Property, plant & Equipment	2	63,500
Non-current investments		50,000
Current assets		
Inventories		15,000
Trade receivables		30,000
Cash and cash equivalents		<u>19,000</u>
Total		<u>1,77,500</u>

Notes to Accounts

		₹
1. Short term borrowings		
Loan from Kaushal		15,900
2. PPE		
Machinery	54,000	
Furniture	<u>9,500</u>	63,500

Working Notes:

1. Calculation of goodwill

	2014-15 ₹	2015-16 ₹	2016-17 ₹	2017-18 ₹	2018-19 ₹
Profits/(Loss)	25,000	12,500	(2,500)	35,000	30,000
Adjustment for extraneous profit of 2014-15 and abnormal loss of 2016-17	(40,000)	-	20,000	—	—
	(15,000)	12,500	17,500	35,000	30,000
Add: Salary of Pratham (750 x 12)	9,000	9,000	9,000	9,000	9,000
	(6,000)	21,500	26,500	44,000	39,000
Less: Interest on non- trading investment	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
	(11,000)	16,500	21,500	39,000	34,000
Total Profit from 2015-16 to 2018-19					1,11,000
Less: Loss for 2014-15					(11,000)
					1,00,000
Average Profit					20,000
Goodwill equal to 3 years' purchase					60,000
Contribution from Rohan for ¼ share					15,000

2. **Calculation of sacrificing ratio of Partners Pratham and Kaushal on admission of Rohan**

	Old share	New share	Sacrificing share	Gaining share
Pratham	3/5	1/2	$\frac{3}{5} - \frac{1}{2} = \frac{6-5}{10} = \frac{1}{10}$	
Kaushal	2/5	1/4	$\frac{2}{5} - \frac{1}{4} = \frac{8-5}{20} = \frac{3}{20}$	
Rohan		1/4		1/4

3. **Goodwill adjustment entry through Partners' capital accounts (in their sacrificing ratio of 2:3)**

	₹	₹
Rohan's capital A/c Dr.	15,000	
To Pratham's capital A/c		6,000
To Kaushal's capital A/c		9,000
(Rohan's share in goodwill adjusted through Pratham and Kaushal)		

4. **Partners' Capital Accounts**

	Pratham ₹	Kaushal ₹	Rohan ₹		Pratham ₹	Kaushal ₹	Rohan ₹
To Drawings (1,000 x 12)	12,000	12,000	12,000	By Balance b/d	50,000	30,000	—
To Pratham			6,000	By General Reserve	12,000	8,000	—
To Kaushal			9,000	By Rohan	6,000	9,000	—
To Balance c/d	79,800	46,900	14,900	By Bank (15,000 + 15,000)	—	—	30,000
				By Profit & Loss A/c	23,800	11,900	11,900
	91,800	58,900	41,900		91,800	58,900	41,900

5. **Balance Sheet of the firm as on 31st March, 2020**

Liabilities	₹	₹	Assets	₹	₹
Pratham's Capital	79,800		Machinery	60,000	

Kaushal's Capital	46,900		Less: Depreciation	(6,000)	54,000
Rohan's Capital	<u>14,900</u>	1,41,600	Furniture	10,000	
			Less: Depreciation	(500)	9,500
Kaushal's Loan	15,000		Investments		50,000
Add: Interest due	<u>900</u>	15,900	Stock-in-trade		15,000
Creditors		20,000	Debtors		30,000
			Cash (W.N.6)		19,000
		<u>1,77,500</u>			<u>1,77,500</u>

6. **Cash balance as on 31.3.2020**

	₹	₹
Cash trading profit		50,000
Add: Investment Interest		5,000
Add: Decrease in Stock Balance		<u>5,000</u>
		60,000
Less: Increase in Debtors	9,000	
Less: Decrease in Creditors	<u>20,000</u>	<u>(29,000)</u>
		31,000
Add: Opening cash balance	5,000	
Add: Cash brought in by Rohan	<u>30,000</u>	<u>35,000</u>
		66,000
Less: Drawings (12,000 +12,000 +12,000)	36,000	
Less: Additions to Machine (60,000 - 54,000)	6,000	
Furniture (10,000 - 5,000)	<u>5,000</u>	<u>(47,000)</u>
Closing cash balance		<u>19,000</u>

7. **Distribution of shares – Conversion into Company**

	₹
Capital :	
Pratham	79,800
Kaushal	46,900
Rohan	<u>14,900</u>
Share Capital	<u>1,41,600</u>
Distribution of shares:	
Pratham (1/2)	70,800
Kaushal (1/4)	35,400
Rohan (1/4)	35,400

Pratham and Kaushal should withdraw capital of ₹ 9,000 (₹ 79,800 – ₹ 70,800) and ₹ 11,500 (₹ 46,900 – ₹ 35,400) respectively and Rohan should subscribe shares of ₹ 20,500 (₹ 35,400 – ₹ 14,900).

3. (a) **Number of Shares to be issued to Partners**

	₹
Assets: Machinery ₹ 1,40,000 + Inventory ₹ 1,37,400 + Trade Receivable ₹ 1,24,000 + Bank ₹ 1,00,000	5,01,400
Less: Liabilities taken over	(1,69,400)
Net Assets taken over (Purchase Consideration)	3,32,000

Classes of Shares to be issued :	Mohit	Neel	Om	Total
10% Preference Shares of ₹ 10 each (to retain rights as to Interest on Capital)	1,36,000	90,000	46,000	2,72,000
Balance in Equity Shares of ₹ 10 each (3,32,000 - 2,72,000) (issued in profit sharing ratio)	30,000	18,000	12,000	60,000
	<u>1,66,000</u>	<u>1,08,000</u>	<u>58,000</u>	<u>3,32,000</u>

(b) **Partners' Capital Accounts**

Particulars	Mohit	Neel	Om	Particulars	Mohit	Neel	Om
To Drawings	50,000	46,000	34,000	By balance b/d	1,36,000	90,000	46,000
To 10% Preference share capital	1,36,000	90,000	46,000	By Interest on Capital	13,600	9,000	4,600
To Equity Shares	30,000	18,000	12,000	By profit for the year 5:3:2 (W.N. 1)	1,10,700	66,420	44,280
To Bank – Additional drawings (W.N. 2)	54,300	17,420	6,880	By Machinery* A/c	10,000	6,000	4,000
Total	2,70,300	1,71,420	98,880		2,70,300	1,71,420	98,880

* Gain on Transfer of Machinery = ₹ 1,40,000 – (₹ 2,00,000 – ₹ 80,000) = ₹ 20,000 in 5:3:2 ratio.

(c) Balance sheet of MNO Ltd. as on 31st March, 2019 (after Takeover of Firm)

		Note no.	₹
I	Equity and Liabilities:		
	(1) Shareholders Funds		
	Share Capital	1	3,32,000
	(2) Current Liabilities		
	Trade Payables		<u>1,69,400</u>
	Total		<u>5,01,400</u>
II	Assets		
	(1) Non-Current Assets		
	Property, plant & equipment		1,40,000
	(2) Current Assets:		
	(a) Inventories		1,37,400
	(b) Trade Receivables		1,24,000
	(c) Cash and Cash Equivalents		<u>1,00,000</u>
	Total		<u>5,01,400</u>

Notes to Accounts

	Particulars	₹
1.	Shares capital	
	Authorised shares capital	<u>20,00,000</u>
	Issued, Subscribed & paid up	
	6,000 Equity Shares of ₹ 10 each	60,000
	27,200 10% Preference Shares capital of ₹ 10 each	<u>2,72,000</u>
	(All above shares issued for consideration other than cash, in takeover of partnership firm)	3,32,000

Working Note:

1. Profit & Loss Appropriation Account for the year ended 31st March, 2019

Particulars	₹	₹	Particulars	₹
To Interest on Capital:			By Net Profit	2,48,600
Mohit [₹ 1,36,000 x 10%]	13,600		(given)	
Neel [₹ 90,000 x 10%]	9,000			
Om [₹ 46,000 x 10%]	<u>4,600</u>	27,200		

To Profits transferred to Capital in profit sharing ratio 5:3:2				
Mohit	1,10,700			
Neel	66,420			
Om	<u>44,280</u>	<u>2,21,400</u>		
Total		2,48,600		<u>2,48,600</u>

2. **Statement showing Additional Drawings in Cash**

(a) **Funds available for Drawings**

<i>Add:</i>	Total Drawing of Partners (given)	1,30,000
	Further Funds available for Drawings (1,78,600-1,00,000)	<u>78,600</u>
		2,08,600
<i>Less:</i>	Interest on Capital	<u>(27,200)</u>
	Amount available for Additional Drawings	1,81,400

(b) **Ascertainment of Additional Drawings**

Particulars	Mohit	Neel	Om
As per above statement ₹ 1,81,400 (in profit sharing ratio)	90,700	54,420	36,280
<i>Add:</i> Interest	<u>13,600</u>	<u>9,000</u>	<u>4,600</u>
	1,04,300	63,420	40,880
<i>Less:</i> Already drawn	<u>(50,000)</u>	<u>(46,000)</u>	<u>(34,000)</u>
Additional Drawings	<u>54,300</u>	<u>17,420</u>	<u>6,880</u>

4. **Distinction between an ordinary partnership firm and an LLP**

Key Elements	Partnerships	LLPs
Applicable Law	Indian Partnership Act 1932	The Limited Liability Partnerships Act, 2008
Number of Partners	Minimum 2 and Maximum 20 (subject to 10 for banks)	Minimum 2 but no maximum limit
Ownership of Assets	Firm cannot own any assets. The partners own the assets of the firm.	The LLP as an independent entity can own assets
Liability of Partners/ Members	Unlimited: Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets.	Limited to the extent of their contribution towards LLP except in case of intentional fraud or wrongful act of omission or commission by a partner.

5. Fair value of an option = ₹ 28

Difference between Fair value and Issue Price = ₹ 28 – ₹ 25 = 3.

Number of employees accepting the offer = 400 employees x 50% = 200 employees

Number of shares issued = 200 employees x 100 shares/employee = 20,000 shares

Employee Compensation Expenses recognized in 2019-20 = 20,000 shares x ₹ 3 = ₹ 60,000

Securities Premium A/c = ₹ 28 – 10 = ₹ 18 per share = 20,000 x 18 = ₹ 3,60,000

Journal Entry

Date	Particulars	₹	₹
30.04.2019	Bank (20,000 shares x ₹ 25) Dr.	5,00,000	
	Employees compensation expense A/c Dr.	60,000	
	To Share Capital		2,00,000
	To Securities Premium		3,60,000
	(Being stock purchase option accepted by 200 employees for 100 shares each at ₹ 25 per share on a Fair Value of ₹ 28 per share)		

Note: Employees compensation expenses amounting ₹ 60,000 will ultimately be charged to profit & loss account.

6. (i) **Journal Entries in the books of C Ltd. (₹ in lakhs)**

	Particulars	₹	₹
1	Bank A/c Dr.	2,500	
	To Investments A/c		2,350
	To Profit and Loss A/c		150
	(Being investment sold on profit for the purpose of buy-back)		
2	10% Redeemable Preference Share Capital A/c Dr.	2,500	
	Premium on Redemption of Preference Shares A/c Dr.	250	
	To Preference Shareholders A/c		2,750
	(Being redemption of preference share capital at premium of 10%)		
3	Securities Premium A/c Dr.	250	
	To Premium on Redemption of Preference Shares A/c		250
	(Being premium on redemption of preference shares adjusted through securities premium)		

4	Equity Share Capital A/c Premium on buyback To Equity buy-back A/c (Being Equity Share bought back, Share Capital cancelled, and Premium on Buyback accounted for)	Dr. Dr.	800 800	1,600
5	Securities Premium A/c (800-250) General Reserve A/c To Premium on Buyback A/c (Being premium on buyback provided first out of securities premium and the balance out of general reserves.)	Dr.	550 250	800
6	Preference Shareholders A/c Equity buy-back A/c To Bank A/c (Being payment made to preference shareholders and equity shareholders)		2,750 1,600	4,350
7	General Reserve Account To Capital Redemption Reserve Account (Being amount transferred to capital redemption reserve account towards face value of preference shares redeemed and equity shares bought back)		3,300	3,300

(ii) **Balance Sheet of C Ltd. (after Redemption and Buyback)** (₹ Lakhs)

	Particulars	Note No	Amount
	EQUITY AND LIABILITIES		₹
(I)	Shareholders' Funds:		
	(a) Share Capital	1	7,200
	(b) Reserves and Surplus	2	7,200
(2)	Non-Current Liabilities:		
	(a) Long Term Borrowings	3	5,000
(3)	Current Liabilities:		
	(a) Trade payables		2,300
	(b) Short Term Provisions		<u>1,000</u>
	Total		<u>22,700</u>
(II)	ASSETS		
(1)	Non-Current Assets		

Property, Plant & Equipment	14,000
Current Assets:	
(a) Cash and Cash equivalents (W N)	450
(b) Other Current Assets	<u>8,250</u>
	<u>22,700</u>

Notes to Accounts

		₹ in Lakhs		
1.	Share Capital 720 lakh Equity Shares of ₹ 10 each Fully Paid up (80 lakh Equity Shares bought back)			7,200
2.	Reserves and Surplus			
	General Reserve	6,000		
	Less: Adjustment for premium paid on buy back	(250)		
	Less: Transfer to CRR	<u>(3,300)</u>	2,450	
	Capital Redemption Reserve	1,000		
	Add: Transfer due to buy-back of shares from Gen. res.	<u>3,300</u>	4,300	
	Securities premium	800		
	Less: Adjustment for premium paid on redemption of preference shares	(250)		
	Less: Adjustment for premium paid on buy back	<u>(550)</u>	-	
	Profit & Loss A/c	300		
	Add: Profit on sale of investment	<u>150</u>	<u>450</u>	7,200
3.	Long-term borrowings			
	Secured			
	9 % Debentures			5,000

Working Note**Bank Account**

Receipts	Amount	Payments	Amount
	(₹ Lakhs)		(₹ Lakhs)
To balance b/d	2,300	By Preference Shareholders A/c	2,750
To Investment A/c (sale Proceeds)	2,500	By Equity Shareholders A/c	1,600

		By Balance c/d (Balancing figure)	<u>450</u>
	<u>4,800</u>		<u>4,800</u>

7. **Debenture Redemption Reserve Account**

Date	Particulars	₹	Date	Particulars	₹
31 st March, 20X2	To General reserve A/c note 1 (Refer Note 1)	<u>3,75,000</u>	1 st April, 20X1	By Balance b/d	1,25,000
		3,75,000	1 st April, 20X1	By Profit and loss A/c (Refer Note 1)	<u>2,50,000</u>
					3,75,000

10% Secured Bonds of Govt. (DRR Investment) A/c

		₹			₹
1 st April, 20X1	To Balance b/d	<u>5,62,500</u>	31 st March, 20X2	By Bank A/c	<u>5,62,500</u>
		<u>5,62,500</u>			<u>5,62,500</u>

Bank Account

		₹			₹
31 st March, 20X2	To Balance b/d	37,50,000	31 st March, 20X2	By Debenture Holders A/c (110% of 37,50,000)	41,25,000
	To Interest on DRR Investment (5,62,500X 10%)	56,250		By Balance c/d	<u>2,43,750</u>
	To DRR Investment A/c	<u>5,62,500</u>			43,68,750
		43,68,750			

Working note –

Calculation of DRR before redemption = 10% of ₹ 37,50,000 = 3,75,000

Available balance = ₹ 1,25,000

DRR required = 3,75,000 – 1,25,000 = ₹ 2,50,000.

8. **Computation of liabilities of underwriters (No. of shares):**

	A & Co.	B & Co.	C & Co.	Total
Gross liability	72,000	30,000	18,000	1,20,000
Less: Marked applications (excluding firm underwriting)	<u>(12,000)</u>	<u>(15,000)</u>	<u>(6,000)</u>	<u>(33,000)</u>
	60,000	15,000	12,000	87,000

Less: Unmarked Applications* (Ratio 72:30:18)	(16,200)	(6,750)	(4,050)	(27,000)
	43,800	8,250	7,950	60,000
Less: Firm underwriting	(9,600)	(12,000)	(3,600)	(25,200)
	34,200	(3,750)	4,350	34,800
Credit for excess of B & Co. (ratio 72:18)	(3,000)	3,750	(750)	
Net liability (excluding firm underwriting)	31,200	-	3,600	
Add: Firm underwriting	9,600	12,000	3,600	
Total liability (No. of shares)	40,800	12,000	7,200	

Working Note:

*Total Applications 60,000 Shares

Less: Marked Applications 33,000 Shares

Unmarked applications 27,000 Shares

9.

In the Books of P Ltd.**Realization Account**

		₹			₹
To	Land & Building	4,50,000	By	8% Debentures	2,00,000
To	Plant & Machinery	6,20,000	By	Trade Payables	88,000
To	Furniture & Fitting	1,00,000	By	PQ Ltd.	16,02,100
To	Trade receivables	3,25,000		(Purchase consideration)	
To	Inventory/Stock	2,33,000	By	Equity Shareholders A/c	1,37,900
To	Cash at Bank	2,08,000		(loss)	
To	Cash in Hand	54,000			
To	Preference shareholders (excess payment)	38,000			
		<u>20,28,000</u>			<u>20,28,000</u>

Equity Shareholders Account

		₹			₹
To	Realization A/c (loss)	1,37,900	By	Share capital	8,20,000
To	Equity Shares in PQ Ltd.	10,82,400	By	Profit & Loss A/c	3,52,000
To	Cash	<u>1,01,700</u>	By	General Reserve	<u>1,50,000</u>
		<u>13,22,000</u>			<u>13,22,000</u>

9% Preference Shareholders Account

To	Preference Shares in PQ Ltd.	4,18,000	By	Pref. Share capital	3,80,000
		<u> </u>	By	Realization A/c	<u>38,000</u>
		4,18,000			4,18,000

PQ Ltd. Account

To	Realization A/c	16,02,100	By Shares in PQ Ltd.		
			For Equity	10,82,400	
			For Pref.	<u>4,18,000</u>	15,00,400
		<u> </u>	By Cash		<u>1,01,700</u>
		16,02,100			16,02,100

8% Debentures holders Account

₹	₹
To 6% Debentures	2,00,000
By 8% Debentures	<u>2,00,000</u>

Books of Q Ltd.**Realization Account**

		₹			₹
To	Land & Building	3,40,000	By	8% Debentures	1,00,000
To	Plant & Machinery	4,50,000	By	Trade payables	1,60,000
To	Furniture & Fittings	50,000	By	Unsecured loan	1,75,000
To	Trade receivables	1,50,000	By	PQ Ltd. (Purchase consideration)	7,92,250
To	Inventory	1,05,000	By	Equity Shareholders A/c	90,750
To	Cash at bank	1,75,000		Loss	
To	Cash in hand	20,000			
To	Pref. shareholders	<u>28,000</u>			
		13,18,000			<u>13,18,000</u>

Equity Shareholders Account

		₹			₹
To	Equity shares in PQ Ltd.	4,22,400	By	Share Capital	3,20,000
To	Realization	90,750	By	Profit & Loss A/c	2,05,000
To	Cash	<u>61,850</u>	By	General Reserve	<u>50,000</u>
		5,75,000			<u>5,75,000</u>

9% Preference Shareholders Account

	₹		₹
To Preference Shares in PQ Ltd.	3,08,000	By Share capital	2,80,000
		By Realization A/c	<u>28,000</u>
	<u>3,08,000</u>		<u>3,08,000</u>

PQ Ltd. Account

	₹		₹
To Realization A/c	7,92,250	By Equity shares in PQ Ltd.	
		For Equity	4,22,400
		Preference	<u>3,08,000</u>
			7,30,400
		By Cash	<u>61,850</u>
	<u>7,92,250</u>		<u>7,92,250</u>

8% Debentures holders Account

	₹		₹
To 6% Debentures	<u>1,00,000</u>	By 8% Debentures	<u>1,00,000</u>

Working Notes:**(i) Purchase consideration**

	P Ltd. ₹	Q Ltd. ₹
Payable to preference shareholders:		
Preference shares at ₹ 22 per share	4,18,000	3,08,000
Equity Shares at ₹ 22 per share	10,82,400	4,22,400
Cash [See W.N. (ii)]	<u>1,01,700</u>	<u>61,850</u>
	<u>16,02,100</u>	<u>7,92,250</u>

(ii) Value of Net Assets

	P Ltd. ₹	Q Ltd. ₹
Land & Building	4,50,000	3,40,000
Plant & Machinery less 10% Depreciation	5,58,000	4,05,000
Furniture & Fittings less 10% Depreciation	90,000	45,000
Trade receivables less 5%	3,08,750	1,42,500

Inventory less 5%	2,21,350	99,750
Cash at Bank	2,08,000	1,75,000
Cash in hand	<u>54,000</u>	<u>20,000</u>
	18,90,100	12,27,250
Less: Debentures	2,00,000	1,00,000
Trade payables	88,000	1,60,000
Secured Loans	<u>—</u>	<u>(2,88,000)</u>
	16,02,100	7,92,250
Payable in shares	<u>15,00,400</u>	<u>7,30,400</u>
Payable in cash*	<u>1,01,700</u>	<u>(61,850)</u>
(iii)	P	Q
Plant & Machinery	6,20,000	4,50,000
Less: Depreciation 10%	<u>62,000</u>	<u>45,000</u>
	<u>5,58,000</u>	<u>4,05,000</u>
Furniture & Fixtures	1,00,000	50,000
Less: Depreciation 10%	<u>10,000</u>	<u>5,000</u>
	<u>90,000</u>	<u>45,000</u>

*This cash is paid to equity shareholders of both the companies for adjustment of their rights as per intrinsic value of both companies.

10. In the books of Star Ltd.

Journal Entries

Particulars		Amount ₹	Amount ₹
(i)	7% Preference share capital (₹ 100) Dr.	9,00,000	
	To 9% Preference share capital (₹ 80)		7,20,000
	To Capital reduction A/c		1,80,000
	(Being preference shares reduced to ₹ 80 and also rate of dividend raised from 7% to 9%)		

(ii)	Equity share capital A/c (₹ 100 each)	Dr.	10,00,000	
	To Equity share capital A/c (₹ 10 each)			1,00,000
	To Capital reduction A/c			9,00,000
	(Being reduction of nominal value of one share of ₹ 100 each to ₹ 10 each)			
(iii)	Bank A/c	Dr.	50,000	
	To Capital reduction A/c			50,000
	(Being directors refunded the fee amount)			
(iv)	Trade payables A/c (Interest on debentures)	Dr.	26,000	
	To Capital reduction A/c			26,000
	(Being interest forgone by the debenture holders)			
(v)	No entry required			
(vi) a	'B' 6% Debentures A/c	Dr.	3,50,000	
	To Debentures holders A/c			3,50,000
	(Being amount due to Debentures holders)			
b	Debentures holders A/c	Dr.	4,40,000	
	To Chennai Works A/c			4,25,000
	To Equity share capital A/c			15,000
	(Being Chennai works taken over and equity shares issued to 'B' 6% Debenture holders)			
c	Equity share of Zia Ltd. A/c	Dr.	90,000	
	To Debentures holders A/c			90,000
	(Being 9,000 equity shares of Zia Ltd. issued by Debentures holders)			
(vii) a	Chennai Works – Workmen Compensation Fund	Dr.	4,000	
	To Capital reduction A/c			4,000
	(Being difference due to reduced amount of actual liability transferred to capital reduction account)			
b	Bank A/c	Dr.	15,400	
	To Investment for Workmen Compensation Fund			14,000

	To Capital reduction A/c (Being investment for Workmen Compensation Fund sold @ 10% profit)			1,400
c	Trade Payables A/c	Dr.	15,400	
	To Bank A/c (Being part payment made to trade payables)			15,400
(viii)	Capital reduction A/c	Dr.	2,10,000	
	To Provision for Doubtful Debts A/c			20,000
	To Inventory A/c (Being assets revalued)			1,90,000
(ix)	Capital reduction A/c	Dr.	5,50,000	
	To Profit & Loss A/c			2,00,000
	To PPE – Chennai Works (Being assets revalued and losses written off)			3,50,000*
(x)	Capital reduction A/c	Dr.	4,01,400	
	To PPE – Bombay Works			2,67,600
	To Capital reserve A/c (Being assets revalued and remaining amount transferred to capital reserve account)			1,33,800

11. Calculation of Total Remuneration payable to Liquidator

	Amount in ₹
2% on Assets realised 37,50,000 x 2%	75,000
3% on payment made to Preferential creditors 1,12,500 x 3%	3,375
3% on payment made to Unsecured creditors (Refer W.N)	<u>58,882</u>
Total Remuneration payable to Liquidator	<u>1,37,257</u>

* ₹ 7,75,000 less ₹ 4,25,000

Working Note:**Liquidator's remuneration on payment to unsecured creditors**

Cash available for unsecured creditors after all payments including liquidation expenses, payment to secured creditors, preferential creditors & liquidator's remuneration

$$= ₹ 37,50,000 - ₹ 37,500 - ₹ 15,00,000 - ₹ 1,12,500 - ₹ 75,000 - ₹ 3,375 \\ = ₹ 20,21,625.$$

Liquidator's remuneration

$$= 3/103 \times ₹ 20,21,625 = ₹ 58,882$$

12. (a) Form B – RA

Name of Insurer: M/s Jagan Co.

Revenue Account for the year ended 31st March, 2019

		<i>Schedule</i>	<i>Current Year</i>
			₹
1.	Premium earned (net)	1	3,29,000
2.	Interest, Dividends and Rent – Assumed Gross		<u>18,000</u>
	Total (A)		<u>3,47,000</u>
1.	Claims incurred (net)	2	92,400
2.	Commission	3	93,600
3.	Operating expenses related to Insurance business	4	<u>46,600</u>
	Total (B)		<u>2,32,600</u>
	Operating Profit from Marine Insurance business (A-B)		<u>1,14,400</u>

Schedules forming part of Revenue Account

	<i>Current Year</i>
	₹
Schedule –1	
Premium earned (net)	
Total Premium earned	4,04,200
Less: Premium on reinsurance ceded	<u>(25,200)</u>
Total Premium earned (net)	3,79,000
Adjustment for change in reserve for unexpired risk (3,50,000-3,00,000)	<u>50,000</u>
Net Premium earned	<u>3,29,000</u>

Schedule – 2	
Claims incurred (net) (1,52,000+18,300-78,100)	92,400
Schedule – 3	
Commission paid	
Direct	96,000
Add: Re-insurance accepted	5,600
Less: Re-insurance ceded	<u>(8,000)</u>
Net Commission	<u>93,600</u>
Schedule – 4	
Operating expenses related to insurance business	
Establishment expenses	30,000
Rent, rates and taxes	14,000
Printing and stationery	1,800
Legal and professional charges ₹ (2,000-1,200)	<u>800</u>
	<u>46,600</u>

Working Notes:

		Direct	Re-insurance
		₹	₹
1. Total Premium Income			
Received	3,60,000	38,000	
Add: Receivable on 31 st March, 2019	<u>16,000</u>	<u>1,800</u>	
	3,76,000	39,800	
Less: Receivable on 1 st April, 2018	<u>(10,000)</u>	<u>(1,600)</u>	
	<u>3,66,000</u>	<u>38,200</u>	

Total premium income ₹ 3,66,000 + ₹ 38,200 = ₹ 4,04,200

2. Premium Expense on reinsurance	₹
Premium Paid during the year	24,000
Add: Payable on 31 st March, 2019	<u>2,200</u>
	26,200
Less: Payable on 1 st April, 2018	<u>(1,000)</u>
	<u>25,200</u>
3. Claims Paid	
Direct Business	1,54,000
Re-insurance	14,000

	Legal Expenses	<u>1,200</u>
		1,69,200
	Less: Re-insurance claims received	<u>(17,000)</u>
		<u>1,52,200</u>
4.	Claims outstanding as on 31st March, 2019	
	Direct	16,000
	Re-insurance	<u>4,200</u>
		20,200
	Less: Recoverable from Re-insurers on 31 st March, 2019	<u>(1,900)</u>
		<u>18,300</u>
5.	Claims outstanding as on 1st April, 2018	
	Direct	78,000
	Re-insurance	<u>1,500</u>
		79,500
	Less: Recoverable from Re-insurers on 1 st April, 2018	<u>(1,400)</u>
		<u>78,100</u>
6.	Claims incurred during the year	
	Net Claims Paid + Claims outstanding on 31.3.2019 – Claims outstanding on 1.4.2018 = ₹ 1,52,200 + ₹ 18,300 – ₹ 78,100	92,400

13.

In the books of Anmol bank Ltd.

Journal Entries

₹ in crores

Particulars	Debit	Credit
Rebate on bills discounted A/c Dr.	40	
To Discount on bills A/c		40
(Being the transfer of opening balance in 'Rebate on bills discounted A/c' to 'Discount on bills A/c')		
Bills purchased and discounted A/c Dr.	5,000	
To Discount on bills A/c		280
To Clients A/c		4,720
(Being the discounting of bills of exchange during the year)		
Discount on bills A/c Dr.	14	
To Rebate on bills discounted A/c		14
(Being the unexpired portion of discount in respect of the discounted bills of exchange carried forward)		

Discount on bills A/c	Dr.	306	
To Profit and Loss A/c			306
(Being the amount of income for the year from discounting of bills of exchange transferred to Profit and loss A/c)			

Working Notes:

- Discount received on the bills discounted during the year**
 $\text{₹ } 5,000 \text{ crores} \times 14/100 \times 146/365 = \text{₹ } 280 \text{ crores}$
- Calculation of rebate on bill discounted**
 $\text{₹ } 500 \text{ crores} \times 14/100 \times 73/365 = \text{₹ } 14 \text{ crores}$
- Income from bills discounted transferred to Profit and Loss A/c would be calculated by preparing Discount on bills A/c.

Discount on bills A/c			₹ in crores		
Date	Particulars	Amount	Date	Particulars	Amount
31.3.2019	To Rebate on bills discounted	14	1.4.2018	By Rebate on bills discounted b/d	40
"	To Profit and Loss A/c (Bal. Fig.)	<u>306</u>	2018-19	By Bills purchased and discounted	<u>280</u>
		<u>320</u>			<u>320</u>

14. (a) (i) Floor area occupied by each department (if given) otherwise on time basis;
(ii) Value of assets of each department otherwise on time basis;
(iii) Wages and salaries of each department;
(iv) Purchases of each department;
(v) Consumption of energy by each department.

(b) Calculation of Correct Profit

	Department X	Department Y	Department Z
	₹	₹	₹
Profit after charging managers' commission	1,80,000	1,35,000	90,000
Add back: Managers' commission (1/9)	<u>20,000</u>	<u>15,000</u>	<u>10,000</u>
	2,00,000	1,50,000	1,00,000
Less: Unrealized profit on stock (W.N.)	<u>(24,500)</u>	<u>(22,500)</u>	<u>(10,000)</u>

Profit before Manager's commission	1,75,500	1,27,500	90,000
Less: Commission for Department Manager @ 10%	<u>(17,550)</u>	<u>(12,750)</u>	<u>(9,000)</u>
Departmental Profits after manager's commission	<u>1,57,950</u>	<u>1,14,750</u>	<u>81,000</u>

Working Note:**Stock lying with**

	Dept. X	Dept. Y	Dept. Z	Total
	₹	₹	₹	₹
Unrealized Profit of:				
Department X		$\frac{1}{5} \times 75,000$ = 15,000	$\frac{20}{120} \times 57,000$ = 9,500	24,500
Department Y	$0.15 \times 70,000$ = 10,500		$0.20 \times 60,000$ = 12,000	22,500
Department Z	$\frac{20}{120} \times 30,000$ = 5,000	$\frac{25}{125} \times 25,000$ = 5,000		10,000

15. (i)

Books of Branch**Journal Entries**

		(₹ in lacs)
	Dr.	Cr.
Goods in Transit A/c Dr. To Head Office A/c (Goods dispatched by head office but not received by branch before 1st April, 2019)	10	10
Expenses A/c Dr. To Head Office A/c (Amount charged by head office for centralised services)	1	1

(ii)

Trading and Profit & Loss Account of the Branch**for the year ended 31st March, 2019**

	₹ in lacs		₹ in lacs
To Opening Stock	60	By Sales	360
To Goods received from Head Office	288	By Closing Stock	62

Less: Returns (5)	283		
To Carriage Inwards	7		
To Gross Profit c/d	<u>72</u>		
	<u>422</u>		<u>422</u>
To Salaries	25	By Gross Profit b/d	72
To Depreciation on Furniture	2		
To Rent	10		
To Advertising	6		
To Telephone, Postage & Stationery	3		
To Sundry Office Expenses	1		
To Head Office Expenses	1		
To Net Profit Transferred to Head Office A/c	<u>24</u>		
	<u>72</u>		<u>72</u>

Balance Sheet as on 31st March, 2019

Liabilities	₹ in lacs		Assets	₹ in lacs	
Head Office	80		Furniture & Equipment	20	
Add: Goods in transit	10		Less: Depreciation	<u>(2)</u>	18
Head Office Expenses	1		Stock in hand		62
Net Profit	<u>24</u>		Goods in Transit		10
		115	Debtors		20
Outstanding Expenses	<u>3</u>		Cash at bank and in hand		<u>8</u>
		<u>118</u>			<u>118</u>

16. A liability is recognised when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. In the given case, A Ltd. should recognise a liability of ₹ 1,00,000 to Gamma Ltd.

When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognised as an expense rather than as an asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognised as an expense.

Journal entry

Loss on change in production method To Gamma Ltd. (Loss due to change in production method)	Dr.	1,00,000	1,00,000
Profit and loss A/c To Loss on change in production method (loss transferred to profit and loss account)	Dr.	1,00,000	1,00,000

17. (a) According to AS 4 on 'Contingencies and Events Occurring after the Balance Sheet Date', adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. However, adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. "Contingencies" used in the Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.
- Fire has occurred after the balance sheet date and also the loss is totally insured. Therefore, the event becomes immaterial and the event is **non-adjusting** in nature.
 - The contingency is restricted to conditions existing at the balance sheet date. However, in the given case, suit was filed against the company's advertisement by a party on 10th April for amount of ₹ 20 lakhs. Therefore, it does not fit into the definition of a contingency and hence is a non-adjusting event.
- (b) As per para 31 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.
- Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.
 - Similarly, the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial will not be treated as a change in an accounting policy
18. (a) (i) As per AS 11 "The Effects of Changes in Foreign Exchange Rates", an enterprise may enter into a forward exchange contract to establish the amount of the reporting currency required, the premium or discount arising at the inception of such a forward exchange contract should be amortized as expenses or income over the life of the contract.

Forward Rate	₹ 62.50
Less: Spot Rate	(₹ 60.75)
Premium on Contract	₹ 1.75
Contract Amount	US\$ 5,00,000
Total Loss (5,00,000 x 1.75)	₹ 8,75,000

Contract period 5 months

3 months falling in the year 2017-18, therefore loss to be recognized in 2017-18 $(8,75,000/5) \times 3 = ₹ 5,25,000$. Rest ₹ 3,50,000 will be recognized in the following year 2018-19.

- (ii) Financial statements of an integral foreign operation (for example, dependent foreign branches) should be translated using the principles and procedures described in paragraphs 8 to 16 of AS 11 (Revised 2003). The individual items in the financial statements of a foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of transaction. The foreign currency monetary items (for example cash, receivables, payables) should be reported using the closing rate at each balance sheet date. Non-monetary items (for example, fixed assets, inventories, investments in equity shares) which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of transaction. Thus the cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If the fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate. Exchange difference arising on the translation of the financial statements of integral foreign operation should be charged to profit and loss account.

Thus, the treatment by the management of translating all assets and liabilities; income and expenditure items in respect of foreign branches at the prevailing rate at the year end and also the treatment of resultant exchange difference is not in consonance with AS 11 (Revised 2003).

- (b) (i) ₹ 35 lakhs received from the local authority for providing medical facilities to the employees is a grant received in the nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, ₹ 35 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

- (ii) As per AS 12 'Accounting for Government Grants', where the government grants are in the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received from the Central Government for setting up a unit in notified backward area is neither in relation to specific fixed asset nor in relation to revenue. Thus, amount of ₹ 100 lakhs should be credited to capital reserve.

- (iii) ₹ 10 lakhs grant received for installation anti-pollution equipment is a grant related to specific fixed asset. Two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives. Under first method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Under the second method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

Thus, ₹ 10 lakhs may either be deducted from the cost of equipment or treated as deferred income to be recognized on a systematic basis in profit & Loss A/c over the useful life of equipment.

19. (a) According to AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

It also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost

$$= ₹ 12,00,000 - ₹ 3,00,000$$

$$= ₹ 9,00,000$$

Sr. No.	Particulars	Nature of assets	Interest to be capitalized (₹)	Interest to be charged to Profit & Loss Account (₹)
i	Construction of factory building	Qualifying Asset	$9,00,000 \times 40/100$ = ₹ 3,60,000	NIL
ii	Purchase of Machinery	Not a Qualifying Asset	NIL	$9,00,000 \times 35/100$ = ₹ 3,15,000
iii	Working Capital	Not a Qualifying Asset	NIL	$9,00,000 \times 25/100$ = ₹ 2,25,000
	Total		<u>₹ 3,60,000</u>	<u>₹ 5,40,000</u>

- (b) As per AS 19 “Leases”, the lessee should recognize the lease as an asset and a liability at the inception of a finance lease. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payment from the standpoint of the lessee, the amount recorded as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee.

Value of machinery

In the given case, fair value of the machinery is ₹ 10, 00,000 and the net present value of minimum lease payments is ₹ 10, 07,020 (Refer working Note). As the present value of the machine is more than the fair value of the machine, the machine and the corresponding liability will be recorded at value of ₹10,00,000.

Calculation of finance charges for each year

Year	Finance charge (₹)	Payment (₹)	Reduction in outstanding liability (₹)	Outstanding liability (₹)
1 st year beginning	-	-	-	10,00,000
End of 1 st year	1,60,000	3,50,000	1,90,000	8,10,000
End of 2 nd year	1,29,600	3,50,000	2,20,400	5,89,600
End of 3 rd year	94,336	3,50,000	2,55,664	3,33,936
End of 4 th year	53,430	3,50,000	2,96,570	37,366

Working Note:**Present value of minimum lease payments**

Annual lease rental x PV factor ₹ 3,50,000 x (0.8621 + 0.7432 + 0.6407 + 0.5523)	₹ 9,79,405
Present value of guaranteed residual value ₹ 50,000 x (0.5523)	₹ 27,615
	₹ 10,07,020

(c) Computation of basic earnings per share

Net profit for the current year / Weighted average number of equity shares outstanding during the year

$$₹ 75,00,000 / 10,00,000 = ₹ 7.50 \text{ per share}$$

Computation of diluted earnings per share $\frac{\text{Adjusted net profit for the current year}}{\text{Weighted average number of equity shares}}$

Adjusted net profit for the current year

	₹
Net profit for the current year	75,00,000
Add: Interest expense for the current year	8,00,000
Less: Tax relating to interest expense (30% of ₹ 8,00,000)	(2,40,000)
Adjusted net profit for the current year	<u>80,60,000</u>

Number of equity shares resulting from conversion of debentures

= 1,10,000 Equity shares (given in the question)

Weighted average number of equity shares used to compute diluted earnings per share

$$= 11,10,000 \text{ shares } (10,00,000 + 1,10,000)$$

Diluted earnings per share

$$= ₹ 80,60,000 / 11,10,000$$

$$= ₹ 7.26 \text{ per share}$$

Note:

Conversion of convertible debentures into Equity Share will be dilutive potential equity shares. Hence, to compute the adjusted profit the interest paid on such debentures will be added back as the same would not be payable in case these are converted into equity shares.

20. (a) Amortization of cost of patent as per AS 26

Year	Estimated future cash flow (₹ in lakhs)	Amortization Ratio	Amortized Amount (₹ in lakhs)
1	600	.25	300
2	600	.25	300
3	600	.25	300
4	300	.40 (Revised)	120
5	300	.40 (Revised)	120
6	150	.20 (Revised)	<u>60</u>
			<u>1,200</u>

In the first three years, the patent cost will be amortized in the ratio of estimated future cash flows i.e. (600: 600: 600: 300: 300).

The unamortized amount of the patent after third year will be ₹ 300 lakh (1,200-900) which will be amortized in the ratio of revised estimated future cash flows (300:300:150) in the fourth, fifth and sixth year.

- (b) (i) The construction of the oil rig creates an obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil. An outflow of resources embodying economic benefits in settlement is probable. Thus, a provision is recognized for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig. However, there is no obligation to rectify the damage that will be caused by extraction of oil, as no oil has been extracted at the balance sheet date. So, no provision is required for the cost of extraction of oil at balance sheet date.

Ten per cent of costs that arise through the extraction of oil are recognized as a liability when the oil is extracted.

- (ii) As per AS 29, for a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation.

The obligating event is the giving of the guarantee by Ace Ltd. for certain borrowings of Brew Ltd., which gives rise to an obligation. No outflow of benefits is probable at 31 March 2019. Thus no provision is recognized. The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

During 2019-20, the financial condition of Brew Ltd. deteriorates and finally goes into liquidation. The obligating event is the giving of the guarantee, which gives rise to a legal obligation. At 31 March 2020, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. Thus, provision is recognized for the best estimate of the obligation.

PAPER – 6: AUDITING AND ASSURANCE

PART – I : ACADEMIC UPDATE

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

Revised Chapter 7-Company Audit-I is given hereunder:

1. Eligibility, Qualifications and Disqualifications of an Auditor



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

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

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

Fig.: Is the person eligible for appointment as auditor?¹

- (2) Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.
- (3) Under **sub-section (3) of section 141** along with **Rule 10** of the Companies (Audit and Auditors) Rules, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely-
 - (a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;
 - (b) an officer or employee of the company;
 - (c) a person who is a partner, or who is in the employment, of an officer or employee of the company;
 - (d) a person who, or his relative or partner -
 - (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company;

¹ Source of image: <http://yourfinancebook.com>

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

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

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

The following points merit consideration in this regard:

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

[The term “relative”, as defined under the Companies Act, 2013, means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including step- son), Son’s wife, Daughter, Daughter’s husband, Brother (including step- brother), Sister (including step- sister).]

EXAMPLES

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

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

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

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

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

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

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

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

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

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

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

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

In the instant case, M/s RM & Co. is an audit firm having partners CA. R and CA. M. Mr. Bee is a relative of CA. R and he is holding shares of Enn Ltd. of face value of ₹ 50,000 only (5,000 shares x ₹ 10 per share).

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

- (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of ₹ 5,00,000; or
 - (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the Company or its Subsidiary, or its Holding or Associate Company or a Subsidiary of such Holding Company, in excess of ₹ 1,00,000.
- (e) a person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed;

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

- (i) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;
 - (ii) commercial transactions which are in the ordinary course of business of the company at arm's length price - like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.
- (f) a person whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel.
- (g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.
- (h) a person who has been convicted by a Court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.
- (i) **a person who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company.**

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

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

In case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners, shall be termed as rendering of services directly or indirectly by the auditor.

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:



- (i) accounting and book keeping services;
- (ii) internal audit;
- (iii) design and implementation of any financial information system;
- (iv) actuarial services;
- (v) investment advisory services;
- (vi) investment banking services;

Fig.: Auditor restrained from entering into certain services²

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

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

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

Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who, **directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company.** Section 144 of the Companies Act, 2013 prescribes certain

² Source of image: webuildbuzz.com

services not to be rendered by the auditor which includes investment banking services.

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

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

CASE STUDY

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

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

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

2. Appointment of Auditor

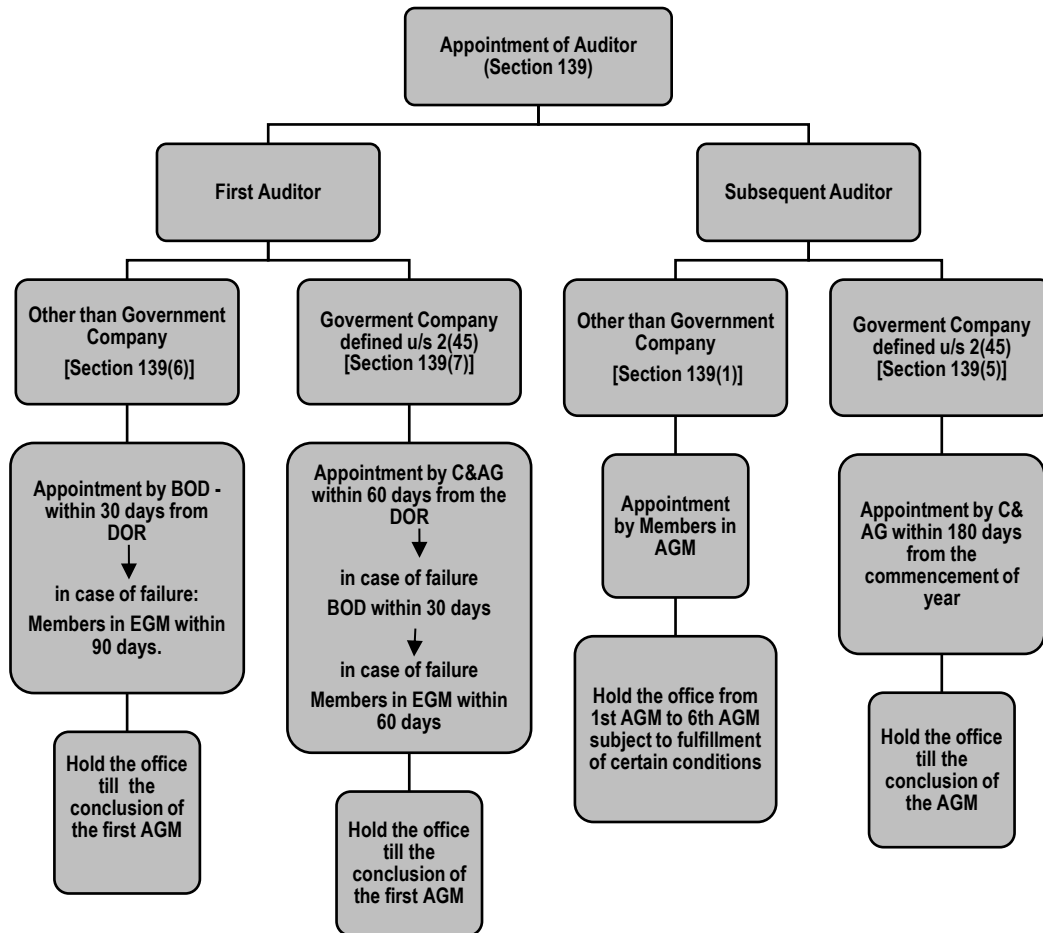


Section 139 of the Companies Act, 2013 contains provisions regarding Appointment of Auditors. Discussion on appointment of auditors may be grouped under two broad headings-

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

Fig: Meeting for appointment of Auditor³

³ Source of image: <http://newhavenscience.org>



2.1 Appointment of First Auditor

2.1.1 Appointment of First Auditors in the case of a company, other than a Government Company: As per **Section 139(6)**, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

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

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

CASE STUDY

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

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

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

2.1.2 Appointment of First Auditors in the case of Government Company: A “Government company” is a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

Section 139(7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

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

CASE STUDY

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

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

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

2.2 Appointment of Subsequent Auditor/Reappointment of Auditor

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

The following points need to be noted in this regard-

- (i) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.
- (ii) The certificate shall also indicate whether the auditor satisfies the criteria provided in **section 141**.
- (iii) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

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

2.3 Filling of a Casual Vacancy

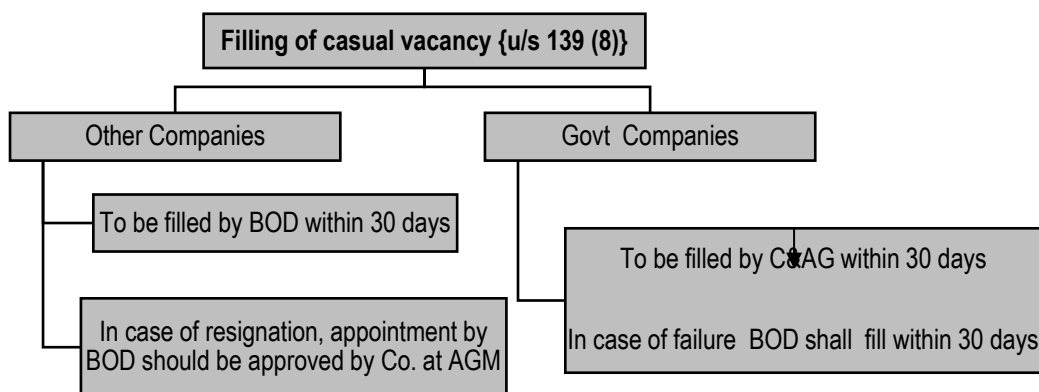
As per **Section 139(8)**, any casual vacancy in the office of an auditor shall-

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

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

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

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



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

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

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

In case of failure, the auditor shall be liable to a penalty of **fifty thousand rupees or the remuneration of the auditor, whichever is less, and in case of continuing failure, with further penalty of five hundred rupees for each day after the first during which such failure continues, subject to a maximum of five lakh rupees** as per **section 140(3)** (Companies (Amendment) Second Ordinance 2019 dated 21 February 2019).

CASE STUDY

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

company and the registrar indicating the reasons and other facts as may be relevant with regard to his resignation.

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

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

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

Other Important Provisions Regarding Appointment of Auditors

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

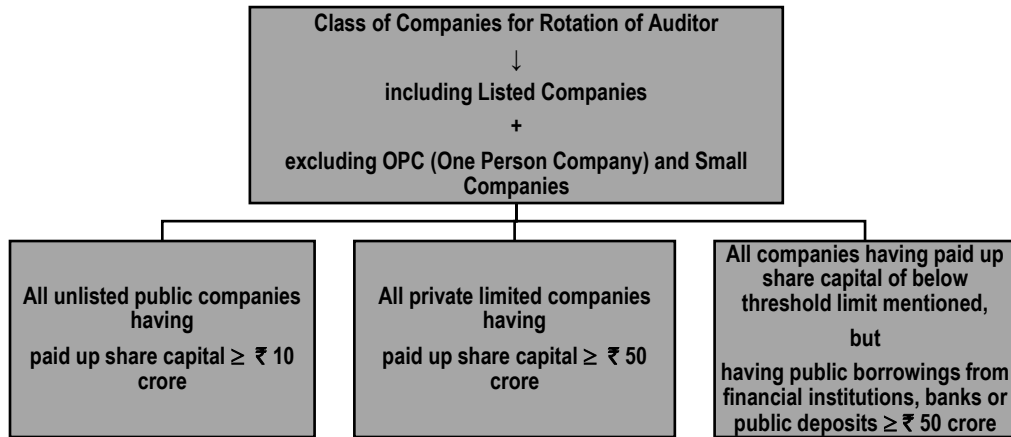
3. Rotation of Auditor

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



Fig: Rotation of Auditors⁴

⁴ Source of image: thehindubusinessline.com



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

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

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

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

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

The following points merit consideration in this regard-

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

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

- (2) Every company, existing on or before the commencement of this Act which is required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section within a period which shall not be later than the date of the first annual general meeting of the company held, within the period specified under sub-section (1) of section 96, after three years from the date of commencement of this Act.

EXAMPLES

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

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

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

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

3.2 Manner of Rotation of Auditors by the Companies on Expiry of their Term: Rule 6 of the Companies (Audit and Auditors) Rules, 2014 prescribes the manner of rotation of auditors on expiry of their term which is given below-

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

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

Explanation II - For the purpose of rotation of auditors,

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

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

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

Note:

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

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

Number of consecutive years for which an audit firm has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period)	Aggregate period which the firm would complete in the same company in view of column I and II
I	II	III
10 Years (or more than 10 years)	3 years	13 years or more
9 years	3 years	12 years
8 years	3 years	11 years
7 years	3 years	10 years
6 year	4 years	10 years
5 years	5 years	10 years
4 years	6 years	10 years
3 year	7 years	10 years
2 years	8 years	10 years
1 years	9 years	10 years

Note:

1. Audit Firm shall include other firms whose name or trade mark or brand is used by the firm or any of its partners.

2. Consecutive years shall mean all the preceding financial years for which the firm has been the auditor until there has been a break by five years or more.
- (4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.

4 Provisions relating to Audit Committee

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

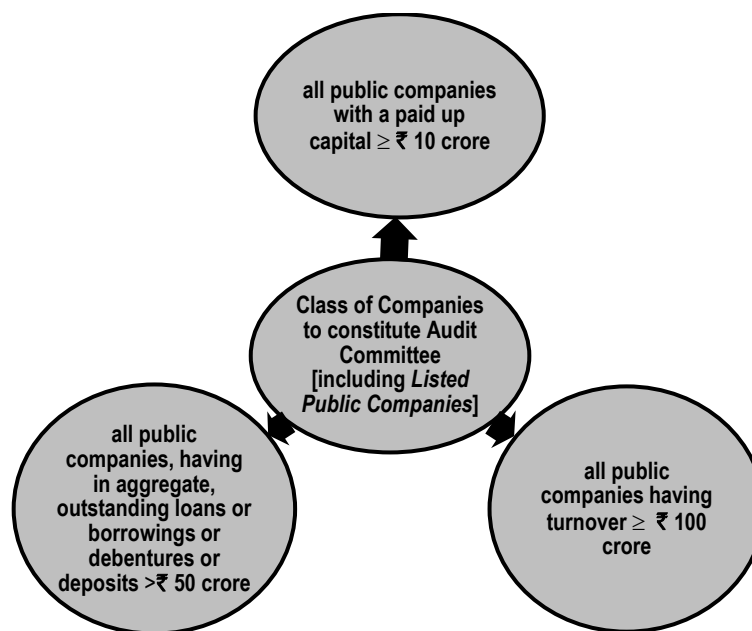


Diagram showing class of companies to constitute Audit Committee

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

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

Explanation- The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial

Statements shall be taken into account for the purposes of this rule.

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

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

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

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

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

wherein such appointment has been made being counted as the first meeting.

5. Auditor's Remuneration

As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. However, board may fix remuneration of the first auditor appointed by it.

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

6. Removal of Auditors

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



Fig: Auditor leaving office of the auditor⁵

(1) The application to the Central Government for removal of auditor shall be made in **Form ADT-2** and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

(2) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.

(3) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

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

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

As per sub-section (5) of the section 140, the Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

⁵ Source of image: www.123rf.com

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

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

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

6.2 Appointment of Auditor Other Than Retiring Auditor: Section 140(4) lays down procedure to appoint an auditor other than retiring auditor who was removed -

- (1) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or as the case may be, ten years, as provided under **sub-section (2) of section 139**.
- (2) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
- (3) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so, -
 - (a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and
 - (b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company. and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

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

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

If the Tribunal is satisfied on an application either of the company or of any other aggrieved

person that the rights conferred by **section 140(4)** of the Companies Act, 2013 are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.

7. Ceiling on Number of Audits

It has been mentioned earlier that before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in **section 141(3)(g)** of the Companies Act, 2013 which prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than **twenty companies** other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore, shall not be eligible for appointment as an Auditor of a Company.

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

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

CASE STUDY

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

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

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

Provisions and Explanations: *Section 141(3)(g) of the Companies Act, 2013 states that the following persons shall not be eligible for appointment as an auditor of a company i.e. a person*

who is in full time employment elsewhere; or a person, or a partner of a firm holding appointment as its auditor, if such person, or partner is at the date of such appointment, or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

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

Conclusion:

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

Total Number of Audits available to the Firm $= 20 \times 3 = 60$

Number of Audits already taken by all the partners

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

Remaining number of Audits available to the Firm $= 40$

- (ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g) - already holding appointments as an auditor. Hence
 (1) Mr. A can hold: $20 - 4 = 16$ more audits. (2) Mr. B can hold $20 - 6 = 14$ more audits and
 (3) Mr. C can hold $20 - 10 = 10$ more audits.
- (iii) In view of above discussed provisions, ABC & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.
- (iv) As per fact of the case, ABC & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than ₹ 100 crores. In the given case, out of the 60 private companies, ABC & Co. is offered 45 companies having paid-up share capital of ₹ 110 crore each.
- Therefore, ABC & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore and 40 private companies having paid-up share capital of ₹ 110 crore each in addition to above 20 company audits already holding.

Council General Guidelines, 2008 (Chapter VIII): In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India hereby specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under

Section 224 and /or Section 226 of the Companies Act, 1956 (now section 141(3)(g) of the Companies Act, 2013).

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

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

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

- (1) In computing the specified number of audit assignments-
 - (a) the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other chartered accountant in practice or firm of such chartered accountants, shall be taken into account.
 - (b) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.
 - (c) a chartered accountant in full time employment elsewhere shall not be taken into account.
- (2) A chartered accountant in practice as well as firm of chartered accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of chartered accountants, or by any of the partner of the firm in his individual name or as a partner of any other firm as far as possible, in the prescribed manner.

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

8. Powers/Rights of Auditors

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

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

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

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

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

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

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

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

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

"all notices of, and other communications relating to, any general meeting shall be forwarded to

the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.”

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

(d) Right to report to the members of the company on the accounts examined by him –

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

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

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

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

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

9. Duties of Auditors

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

(1) Duty of Auditor to Inquire on certain matters: It is the duty of auditor to inquire into the following matters-

- (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
- (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) whether loans and advances made by the company have been shown as deposits;
- (e) whether personal expenses have been charged to revenue account;
- (f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

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

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

or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 143(1)."

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

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

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

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

- (3) **Duty to comply with Auditing Standards:** As per **section 143(9)** of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further, as per **section 143(10)** of the Act, the Central Government may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.
- (4) **Duty to report:** As per **section 143(3)**, the auditor's report shall also state –
- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
 - (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
 - (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
 - (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
 - (e) whether, in his opinion, the financial statements comply with the accounting standards;
 - (f) the observations or comments of the auditors on financial transactions or matters

which have any adverse effect on the functioning of the company;

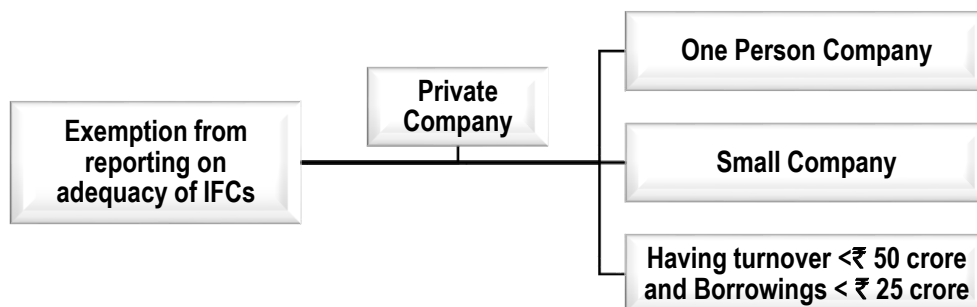
- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of the section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (i) whether the company has adequate internal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

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

(I) **One person company; or**

(II) **Small company; or**

(III) **Company having turnover less than ₹ 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than ₹ 25 crore.**



- (j) such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-
 - (i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
 - (ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

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

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

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

(5) Duty to report on frauds:

A. Reporting to the Central Government- As per **section 143(12)** of the Companies Act, 2013 read with **Rule 13** of the Companies (Audit and Auditors) Rules, 2014, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed.



Fig: Reporting of fraud⁶

B. Reporting to the Audit Committee or Board- In case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.

C. Disclosure in the Board's Report: The companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as prescribed.

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

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

⁶ Source of image: www.oig.jsc.gov

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

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

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

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

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

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

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

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

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

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

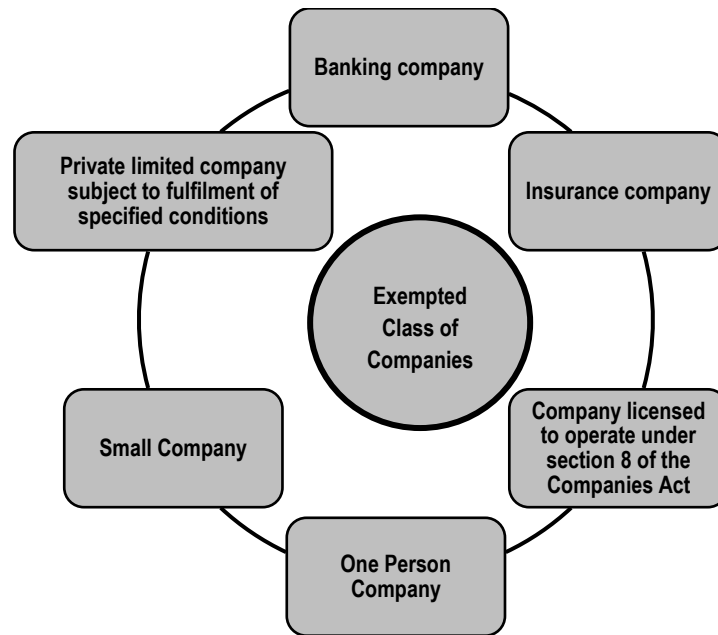
The Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein.

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

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

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (ii) an insurance company as defined under the Insurance Act, 1938;
- (iii) a company licensed to operate under section 8 of the Companies Act;
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act;
- (v) a small company as defined under clause (85) of section 2 of the Companies Act; and
- (vi) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than ₹ 1 crore as on the balance sheet date and which does not have total borrowings exceeding ₹ 1 crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding ₹ 10 crore during the financial year as per the financial statements.

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



EXAMPLES

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

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

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

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

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

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

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
- (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such

verification and if so, whether the same have been properly dealt with in the books of account;

- (c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;
- (ii) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;
- (iii) whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,
 - (a) whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;
 - (b) whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
 - (c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
- (iv) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.
- (v) in case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?
- (vi) where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.
- (vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;
- (b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then

the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not constitute a dispute).

- (viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).
- (ix) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
- (x) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;
- (xi) whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act, 2013? If not, state the amount involved and steps taken by the company for securing refund of the same;
- (xii) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
- (xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;
- (xiv) whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;
- (xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;
- (xvi) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

Reasons to be Stated for Unfavourable or Qualified Answers: Where the answer to any of the questions referred to in **paragraph 3 of the Order** is unfavourable or qualified, in the

auditor's report, the auditor shall also state the basis for such unfavourable or qualified answer, as the case may be.

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

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

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

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

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

11. Disclosure in the Auditor's Report

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

AS-1 – Disclosure of Accounting Policies

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

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

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

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

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

In the event of non-compliance by enterprises not governed by the Companies Act, in situations where the relevant statute does not require such disclosures to be made, the member should make adequate disclosure in his audit report without necessarily making it a subject matter of audit qualification.

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

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

12. Joint Audit

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

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

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

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

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

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

- (i) the engagement partner and other key members of the engagement team from each of the joint auditors should be involved in planning the audit.***
- (ii) the joint auditors should jointly establish an overall audit strategy which sets the scope, timing and direction of the audit, and also guides the development of the audit plan.***
- (iii) before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:***
 - (1) identify division of audit areas and common audit areas;***
 - (2) ascertain the reporting objectives of the engagement;***
 - (3) consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;***
 - (4) consider the results of preliminary engagement activities, or similar engagements performed earlier.***
 - (5) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.***
- (iv) each of the joint auditors should consider and assess the risks of material misstatement and communicate to other joint auditors.***
- (v) the joint auditors should discuss and document the nature, timing, and the extent of the audit procedures for (I) common and (II) specific allotted areas of audit to be performed.***
- (vi) the joint auditors should obtain common engagement letter and common management representation letter.***
- (vii) the work allocation document should be signed by all the joint auditors and communicated to those charged with governance.***

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

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

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

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

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

13. Audit of Branch Office Accounts

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

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

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

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

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

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

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

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

other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

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

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

14. Cost Audit

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

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

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

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

In this regard, the Central Government has notified the Companies (Cost Records and Audit) Rules, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

Applicability for Maintenance of Cost Records: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their

books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006. The said rule has divided the list of companies into (A) Regulated sectors and (B) Non-regulated sectors.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Submission of Cost Audit Report:

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

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

Provided that the companies which have got extension of time of holding AGM under section 96 (1) of the Companies Act, 2013, may file form CRA-4 within resultant extended period of filing financial statements under section 137 of the Companies Act, 2013 (*As per MCA notification dated 3 December 2018*)

If, after considering the cost audit report and the, information and explanation furnished by the company as above, the Central Government is of the opinion, that any further information or

explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

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

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

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

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

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

15. Punishment for non-compliance

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

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

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

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

(3) Where an auditor has been convicted under sub-section (2), he shall be liable to-

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

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

16. Audit report

Management is responsible for the preparation of the financial statements. Management also accepts responsibility for necessary internal controls to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor as to whether the financial statements exhibit a true and fair view of the affairs of the entity.

Thus, an Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent. This involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements. The main users of audit report are shareholders, members and all other stakeholders of the company.

17. Forming an Opinion on the Financial Statements- Objective of the Auditor

17.1 The objectives of the auditor as per SA 700 (Revised), "Forming An Opinion And Reporting On Financial Statements" are:

- (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
- (b) To express clearly that opinion through a written report.

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

17.2 To form opinion - Auditor to obtain Reasonable assurance

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

- (a) whether sufficient appropriate audit evidence has been obtained;
- (b) whether uncorrected misstatements are material, individually or in aggregate;
- (c) The evaluations

17.3 Evaluations by the Auditor



The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

17.3.1 Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:
 - (i) The selective correction of misstatements brought to management's attention during the audit

Example

-  Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
-  The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant

deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

4. SA 540 addresses possible management bias in making accounting estimates.



Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

17.4 Specific Evaluations by the auditor

In particular, the auditor shall evaluate whether :

- (a) The financial statements adequately disclose the significant accounting policies selected and applied;
- (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (c) The accounting estimates made by management are reasonable;
- (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Example:

-  If an amount or disclosure in the financial statements is under greater scrutiny by users of the financial statements, then a smaller misstatement may be considered more significant.
-  A misstatement may be objectively determinable or may involve a degree of subjectivity through estimation, allocation or uncertainty.

17.5 Form of Opinion

Unmodified Opinion: The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Modified Opinion: If the auditor:

(a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,

the **auditor shall modify the opinion** in the auditor's report in **accordance with SA 705**.

17.6 Auditor's Report

The auditor's report shall be in writing. A written report encompasses reports issued in hard copy and those using an electronic medium.

This SA-700 requires the use of specific headings, which are intended to assist in making auditor's reports that refer to audits that have been conducted in accordance with SAs more recognizable.

17.6.1 Auditor's Report for Audits Conducted in Accordance with Standards on Auditing

Basic Elements of an Audit Report are given below:

1 Title: The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

For example, "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.

2. Addressee: The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed.

The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

3. Auditor's Opinion: The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

- (a) Identify the entity whose financial statements have been audited;
- (b) State that the financial statements have been audited;
- (c) Identify the title of each statement comprising the financial statements;
- (d) Refer to the notes, including the summary of significant accounting policies; and
- (e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

Expressing an unmodified opinion on financial statements

When expressing an unmodified opinion on financial statements, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

- (a) In our opinion, the accompanying financial statements **present fairly, in all material respects**, [...] in accordance with [the applicable financial reporting framework]; or
- (b) In our opinion, the accompanying financial statements **give a true and fair view of** [...] in accordance with [the applicable financial reporting framework].

“Present fairly, in all material respects” or “give a true and fair view”

The phrases “present fairly, in all material respects,” and “give a true and fair view” are regarded as being equivalent

When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as “with the foregoing explanation” or “subject to” in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

4. Basis for Opinion:

The auditor's report shall include a section, directly following the Opinion section, with the heading **“Basis for Opinion”**, that:

- (a) States that the audit was conducted in accordance with Standards on Auditing;
- (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
- (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
- (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

5. Going Concern: Where applicable, the auditor shall report in accordance with SA 570 (Revised).

6. Key Audit Matters: For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701.

When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.

Law or regulation may require communication of key audit matters for audits of entities other than listed entities,

For example, entities characterized in such law or regulation as public interest entities.

The auditor may also decide to communicate key audit matters for other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business.

Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities.

7. Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

- (a) **Preparing the financial statements** in accordance with the applicable financial reporting framework, **and for such internal control** as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; [because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and
- (b) **Assessing the entity's ability to continue as a going concern** and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

- ❖ Auditor cannot conclude that management has provided with all relevant information agreed in the terms of the audit engagement agreement without confirming with management whether such information has been provided.
- ❖ When those individuals who have signed the engagement agreement at the start of the audit have left the entity, the auditor would request those who are giving the representations to acknowledge their responsibilities within the letter of representations.

- ❖ A management representation as to the amount required for a particular provision is not a substitute for the audit procedures regarding the provision that the auditor would expect to perform.

Periods covered by the letter: The auditor to obtain representations for all financial statements and periods referred to in our auditor's report. Auditor would obtain a specific representation if a restatement is made to correct a material misstatement in the prior period financial statements that affects the comparative information in the financial statements. If current management was not present during all periods covered by auditor's report, he still would obtain written representations from current management on all such periods.

SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.

Oversight of the financial reporting process: This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from Management. In this case, the heading of this section shall also refer to "Those Charged with Governance"

8. Auditor's Responsibilities for the Audit of the Financial Statements:

The auditor's report shall include a section with the heading "**Auditor's Responsibilities for the Audit of the Financial Statements.**"

This section of the auditor's report shall:

- (a) State that the objectives of the auditor are to:
 - (i) **Obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
 - (ii) **Issue an auditor's report** that includes the auditor's opinion.
- (b) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and
- (c) State that misstatements can arise from fraud or error, and either:
 - (i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or
 - (ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:

- (a) State that, as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and

- (b) Describe an audit by stating that the auditor's responsibilities are:
- (i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- 1. To identify and assess the risks of material misstatement of the financial statements.
 - 2. to design and perform audit procedures in response to those risks
 - 3. to obtain sufficient and appropriate audit evidence.
 - (ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.
 - (iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
 - (iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

- (a) State that **the auditor communicates with those charged with governance** regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;
- (b) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and
- (c) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with SA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure.

9. Location of the description of the auditor's responsibilities for the audit of the financial statements: The description of the auditor's responsibilities for the audit of the financial statements shall be included:

- (a) Within the body of the auditor's report;
- (b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or
- (c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

ILLUSTRATION

The following is an illustration of how such a reference to an appendix could be made in the auditor's report:

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at *[indicate page number or other specific reference to the location of the description]*, forms part of our auditor's report.

10. Other Reporting Responsibilities: If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled -

"Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.

If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs.

If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements stated above shall be included under a section with a heading "Report on the

Audit of the Financial Statements.” The “Report on Other Legal and Regulatory Requirements” shall follow the “Report on the Audit of the Financial Statements.”

11. Signature of the Auditor: The auditor’s report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.

The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them

12. Auditor’s Address: The auditor’s report shall name specific location, which is ordinarily the city where the audit report is signed.

13. Date of the Auditor’s Report: The auditor’s report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements, including evidence that:

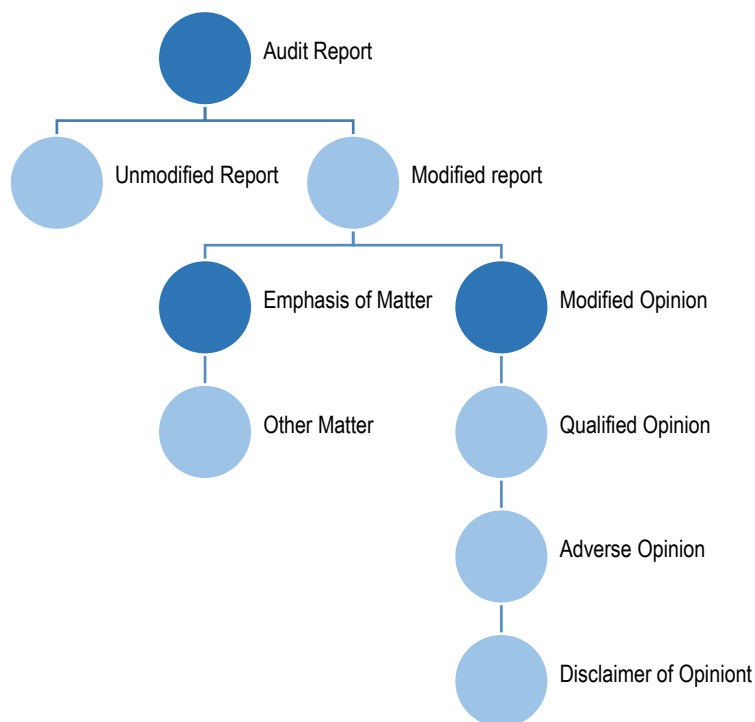
- (a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
- (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

The date of the auditor’s report informs the user of the auditor’s report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor’s responsibility for events and transactions after the date of the auditor’s report is addressed in SA 560.

18. Modifications to the opinion in the independent Auditor’s Report

Standard on Auditing (SA) 705 “Modifications to the opinion in the Independent Auditor’s Report” deals with the auditor’s responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised) “**Forming An Opinion And Reporting On Financial Statements**”, the auditor concludes that a modification to the auditor’s opinion on the financial statements is necessary.

This SA also deals with how the form and content of the auditor’s report is affected when the auditor expresses a modified opinion.



18.1 Circumstances When a Modification to the Auditor's Opinion Is Required

The auditor shall modify the opinion in the auditor's report when:

- (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

18.2 Objective of the auditor - to express clearly an appropriately modified opinion

As per Standard on Auditing (SA) 705 "Modifications To The Opinion In The Independent Auditor's Report", the objective of the auditor is **to express clearly an appropriately modified opinion** on the financial statements that is necessary when:

- (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

18.3 Types of Modified Opinions

There are three types of modified opinions, namely-

1. A qualified opinion
2. An adverse opinion
3. A disclaimer of opinion.

Qualified Opinion	Adverse Opinion	Disclaimer of Opinion
<ul style="list-style-type: none"> The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are material, but not pervasive 	<ul style="list-style-type: none"> The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive 	<ul style="list-style-type: none"> The auditor shall disclaim an opinion when he is unable to obtain sufficient appropriate audit evidence and he concludes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

Qualified Opinion

The auditor shall express a qualified opinion when:

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Adverse Opinion

The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Disclaimer of Opinion The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Definition of Pervasive – A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that, in the auditor's judgment:

- (i) Are not confined to specific elements, accounts or items of the financial statements;
- (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
- (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

18.4 Which type of opinion is appropriate?

The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

18.5 Basis for Opinion

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised)

- (a) Amend the heading "Basis for Opinion" required by para of SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
- (b) Within this section, include a description of the matter giving rise to the modification.

19. Emphasis of matter paragraphs and other matter paragraphs in the independent Auditor's Report.

19.1 Objective of the Auditor as per SA 706

As per SA 706 (Revised) on “Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report”, the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

- (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
- (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Definitions:
Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.
Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

19.2 Emphasis of Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

- (a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and
- (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

19.2.1 Separate section for Emphasis of Matter paragraph

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term “Emphasis of Matter”;

- (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

19.3 Other Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:

- (a) This is not prohibited by law or regulation; and
- (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

19.3.1 Separate section for Other Matter paragraph

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.

20. Communicating Key Audit Matters In The Independent Auditor's Report

Definition of Key Audit Matters: Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

20.1 Purpose of communicating key audit matters

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", the purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

20.2 Objectives of the auditor regarding Key Audit Matters

As per SA 701, "Communicating Key Audit Matters In The Independent Auditor's Report", the objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

20.3 Determining Key Audit Matters

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit.

In making this determination, the auditor shall take into account the following:

- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
- (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- (c) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined in accordance with above stated para were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

20.4 Communicating Key Audit Matters

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters". The introductory language in this section of the auditor's report shall state that:

- (a) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and
- (b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

20.5 Communicating key audit matter- not a substitute for disclosure in the financial statements etc.:

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

- (a) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- (b) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

- (c) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
- (d) A separate opinion on individual matters

In Chapter 5-Vouching, the topic "Payments controlled by the Companies Act, 2013" given at page no. 5.11 has been revised and given hereunder:

In the case of a company, payments or transactions, directly or indirectly, have been controlled/restricted by the Companies Act, 2013 (hereinafter referred as the Act). This may be understood with some of the provisions of the Act as discussed below -

- (i) Only such expenses which are incurred related to the business of the company are chargeable to statement of profit and loss. The auditor is, therefore in terms of section 143(1)(e) of the Act, required to inquire whether personal expenses have been charged to the revenue account. In case of any special comments to the said inquiry, he is also required to report on the same.
- (ii) Section 180 of the Act specifically restricts the powers of the Board *i.e.* the Board of Directors of a company can exercise the following powers but only with the consent of the company by a special resolution, namely -
 - (a) sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company or where the company owns more than one undertaking, of the whole or substantially the whole of any of such undertakings.
 - (b) invest otherwise in trust securities the amount of compensation received by it as a result of any merger or amalgamation.
 - (c) borrow money, where the money to be borrowed, together with the money already borrowed by the company will exceed aggregate of its paid-up share capital and free reserves, apart from temporary loans obtained from the company's bankers in the ordinary course of business.

It is provided that the acceptance by a banking company, in the ordinary course of its business, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise, shall not be deemed to be a borrowing of monies by the banking company within the meaning of this clause.
 - (d) remit, or give time for the repayment of, any debt due from a director.
- (iii) Under section 181, the Board of Directors of a company can contribute to the *bonafide* charitable and other funds any amount in any financial year. However, prior permission of

the company in general meeting is required if the aggregate of such contribution exceeds 5% of its average net profits for the three immediately preceding financial years.

- (iv) Section 182 deals with prohibition and restriction regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. Notwithstanding anything contained in any other provision of this Act, a Company, other than a Government Company and a company which has been in existence for less than three financial years, may contribute any amount directly or indirectly to any political party.

Every company shall disclose in its profit and loss account the total amount contributed by it under this section during the financial year to which the account relates.

The contribution under this section shall not be made except by an account payee cheque drawn on a bank or an account payee bank draft or use of electronic clearing system through a bank account.

- (v) Section 183 permits the Board and other person to make contributions to the National Defence Fund or any other Fund approved by the Central Government for the purpose of National Defence to any extent as it thinks fit.

PART – II: QUESTIONS AND ANSWERS

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

Integrated Case Scenario-1

Moon Group of companies is a retail chain involved in the selling of daily consumer needs directly to the customer. They are in the process of appointing an audit firm for the audit of their accounts for the financial year 2019-20. Moon Group is a South Indian based consumer store having a total of 16 outlets across 4 cities in South India.

Sumant & Co. is appointed as the principal auditor for the entire group. Companies Act 2013 prescribes in detail the terms of this audit engagement. Further, there are many branch auditors appointed for the outlets in the other cities. The company also has an internal audit function conducted on quarterly basis by Ram & Co. Following are the observations during the course of the statutory audit:

- (a) One of the discounts offered by the store is in the form of payback cards where reward points are accumulated and the customer can redeem the same on subsequent purchase. The management and internal auditors are of the opinion that the points redeemed are to be treated as trade discount. The external auditors are doubtful on the matter.

- (b) One of the outlet in Chennai region is in the verge of getting closed and is only left with low value stock to be cleared before closure. During the year, the sales were only around Rs. 1,40,000/- and the auditor considers this component immaterial. All other outlets are performing well with good revenue share.
- (c) The gratuity valuation of the employees of the retail chain is done by an external valuer. The auditor, considering the quantum involved appoints an external auditor's expert for the verification of the actuarial calculation of gratuity.

From the above facts, answer the following questions by choosing the correct answer:

1. As per SA 210 – Agreeing the Terms of Audit Engagement, which of the following statement is correct?
 - (a) Though law prescribes in sufficient detail the terms of the audit engagement, the auditor still needs to record them in a written agreement and also seek written agreement from management that it acknowledges and understands that it has responsibility for the preparation of financial statements.
 - (b) Since law prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement except for the fact that law or regulation applies and also seek written agreement from management that it acknowledges and understands that it has responsibility for the preparation of financial statements.
 - (c) The auditor has to take an extract of the law prescribing the details of the terms of the audit engagement and obtain the counter signature of the management in it.
 - (d) Though law prescribes in sufficient detail the terms of the audit engagement, the auditor still needs to record them in a written agreement, however it need not seek written agreement from management that it acknowledges and understands that it has responsibility for the preparation of financial statements.
2. With respect to the treatment of discount on redemption of points in payback card, what should be the action of the external auditor?
 - (a) The auditor can place reliance and go by the opinion of the branch auditor and internal auditor as they have only done a thorough and detailed audit of the accounts
 - (b) The auditor can place reliance on the management's accounting policy as prima facie they are only responsible for preparation of financial statements.
 - (c) The external auditor has sole responsibility for the audit opinion expressed and hence he should perform procedures to satisfy himself on the correct treatment and issue opinion accordingly.
 - (d) The auditor can advise management on correct treatment but cannot qualify his opinion as branch auditor's opinion has higher authority than external auditor's opinion.

3. What is the main objective of the external auditor, when he uses the work of the internal audit function of Ram & Co.?
 - (a) To determine as to which areas, what extent the work can be used and whether that work is adequate for the purposes of the audit.
 - (b) To appropriately direct, supervise and review the work of the internal audit function
 - (c) Review the internal audit report and audit the areas not covered by the internal audit function
 - (d) Enquire from management on the special points that arose during internal audit and follow up on the course of action on those points.
4. The external auditor finds that the branch auditor of the outlet in the Chennai region, which is in the verge of closing down, is audited by an auditor who is not a member of the Institute of Chartered accountants of India. What should the external auditor do?
 - (a) Since the professional competence of the auditor is in question, the external auditor should himself visit the premise and audit the accounts.
 - (b) Since the financial statement of the component is immaterial, the provisions of SA 600 do not apply.
 - (c) The auditor can rely on the financial statements of that component by obtaining written representation from management that the branch auditor is otherwise well qualified.
 - (d) Since the professional competence of the auditor is in question, the external auditor should co-ordinate with the branch auditor and call for the books of accounts and other explanations.
5. Which of these is not a factor affecting the external auditor's evaluation of the objectivity of the internal audit function?
 - (a) Whether the organizational status of the internal audit function supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgment.
 - (b) Whether the internal audit function is free of any conflicting responsibilities.
 - (c) Whether the internal auditors have adequate technical training and proficiency in auditing.
 - (d) Whether those charged with governance oversee employment decisions related to internal audit function.

Integrated Case Scenario-2

M/s JK & Associates have been appointed as auditors of Venus Ltd. for the financial year 2019-20. The team consist of Mr. J & Mr. K both Chartered Accountants as also the engagement partners and the audit staff consisting of 2 article assistants. While starting the audit work of

Venus Ltd, the engagement partners briefed the audit staff about the audit work, areas to be covered and the various auditing concepts and their application in the audit of Venus Ltd along with applicable Standard on Auditing.

Various topics like audit planning, overall audit strategy, audit programme were discussed in detail. The team was told about the purpose and implication of various statements and guidance notes issued by the Institute of Chartered Accountants of India (ICAI) from time to time. Mr. K also briefed the team about the concept of materiality to be applied while planning and performing audit. The team was also explained in detail about the area where benchmark materiality can be applied in case of Venus Ltd.

Based on the above facts, answer the following:-

1.sets the scope, timing & direction of the audit and guides the development of the more detailed plan.
 - (a) Audit Programme
 - (b) Overall Audit Strategy
 - (c) Completion Memorandum
 - (d) Audit Plan
2. Statement 1: The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential process but are closely inter-related.
Statement 2: The auditor shall establish an overall audit strategy that guides the development of audit plan.
 - (a) Only Statement 1 is correct
 - (b) Only Statement 2 is correct
 - (c) Both Statements 1 & 2 are correct
 - (d) Both Statements 1 & 2 are incorrect
3. means the amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatement exceeds materiality for the financial statements as a whole :-
 - a. Benchmark Materiality
 - b. Materiality in Planning
 - c. Performance Materiality
 - d. Materiality.

4. Which of the following is not an example of benchmark that can be used in determining the materiality in the case of financial statements:-
- Total Revenue
 - Profit before tax
 - Net Asset Value
 - None of the above
5. (i) Guidance notes issued by ICAI provide guidance to members on matters which may arise in the course of their professional work.
- (ii) Statements are issued by ICAI with a view to secure compliance by members on some matters.
- (iii) Guidance notes are recommendatory in nature.
- (iv) Statements are mandatory in nature.
- All the above statements are correct.
 - Statements 1 & 2 are correct
 - Statements 1, 2 & 3 are correct
 - Statements 1, 2 & 4 are correct

MCQ's not based on Case Scenario

1. Statement 1: Audit procedures consist of Risk Assessments Procedures and other procedures.
- Statement 2: Substantive procedures consist of test of details and analytical procedures.
- Only Statement 1 is correct
 - Only Statement 2 is correct
 - Both 1 & 2 are correct
 - Both 1 & 2 are incorrect
2. With respect to the forms specified by companies (Cost Records & Audit) Rule 2014, which of the following is incorrect combination:-
- Form CRA 1- Maintenance of cost records by the Company.
 - Form CRA 2- Intimation of appointment of another cost auditor to Central Government.
 - Form CRA 3- Submission of Cost Audit Report to the Board of Directors of the company.
 - Form CRA 4- Submission of Cost Audit Report by the company to the Registrar.
3. Statement I As per the Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of

plausible relationships among financial data.

Statement II Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

- (a) Only Statement I is correct
 - (b) Only Statement II is correct
 - (c) Both statements are correct
 - (d) Both Statements are incorrect
4. Which of the following is not an example of Analytical Procedures having consideration of comparisons of the entity's financial information :
- (a) Comparable information for prior periods.
 - (b) Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
 - (c) Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
 - (d) Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
5. Statement I : A firm whereof majority of partners practising in India are qualified for appointment may be appointed by its firm name to be auditor of a company.
- Statement II : Where a firm including a limited liability partnership is appointed as an auditor of a company, all the partners shall be authorised to act and sign on behalf of the firm.
- (a) Only Statement I is correct
 - (b) Only Statement II is correct
 - (c) Both statements are correct
 - (d) Both Statements are incorrect

PART II B – DESCRIPTIVE QUESTIONS

1. State with reason (in short) whether the following statements are true or false:
- (i) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding hundred crore rupees or more shall constitute an Audit Committee.

- (ii) According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a general resolution of the company.
- (iii) As per sub-section (5) of the section 140, the Tribunal cannot direct the company to change its auditors.
- (iv) SA 210 does not require the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.
- (v) Government audit does not serve as a mechanism or process for public accounting of government funds.
- (vi) The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.
- (vii) An Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and correct representation of the transactions they claim to represent.
- (viii) An auditor should issue disclaimer of opinion when there is difference of opinion between him and the management on a particular point.
- (ix) Statistical sampling has narrower application where a population to be tested consists of a large number of similar items.
- (x) Risk assessment procedures are not performed to obtain an understanding of the entity and its environment.

Chapter 1- Nature, Objective and Scope of Audit

- 2. (a) The person conducting audit should take care to ensure that financial statements would not mislead anybody. Explain stating clearly the meaning of Auditing.
- (b) Explain the objectives of an Audit as per SA 200.
- 3. (a) There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain with examples.
- (b) In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters.
- 4. Discrepancies in the accounting records, including transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy is one of the example of circumstances that indicate the possibility of fraud. Explain at least four other such examples relating to discrepancies in the accounting records.

Chapter 2- Basic Concepts in Auditing

- 5. (a) Define the following :
 - (i) Positive confirmation request

- (ii) Negative confirmation request
 - (iii) Non-response
 - (iv) Exception
- (b) When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.

Chapter 3- Preparation for an Audit

6. (a) Plans should be further developed and revised as necessary during the course of the audit. Explain.
- (b) Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The process of establishing the overall audit strategy assists the auditor to determine such matters as for example -the resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters. Explain the other three such matters.
7. (a) Knowledge of the Client's business is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible. As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an understanding of the relevant industry, regulatory and other external factors including the applicable financial reporting framework. Substantiate with the help of examples.
- (b) Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques.
- Analyse and Explain with the help of example of evidence in respect of Sales.
8. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Explain stating clearly objectives of the auditor regarding written representation.
9. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. Explain
10. Explain the method which involves selection of a block(s) of contiguous items from within the population. Also give example.

Chapter 4- Risk Assessment and Internal Control

11. (a) When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements. Explain
- (b) Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain giving examples.
12. (a) Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.
- (b) It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Explain with the help of example in respect of the procedure for sales.

Chapter 5 and 6- Vouching and Verification of Assets and Liabilities

13. Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS). In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards. Explain with example stating the relevant assertions involved in this regard. Also explain financial statement audit.
14. What does the Valuation assertion mean in respect of Assets, liabilities and equity balances? Explain with the help of example in respect of Inventory.
15. How will you vouch/verify the following?
 - (a) Receipt of Capital subsidy
 - (b) Bank balances
 - (c) Sales commission expenditure
 - (d) Advance to suppliers

Chapter 7 and 8 - The Company Audit -1 and 2

16. ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report.

17. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.
18. (a) The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ₹ 50 lakh and cleared all the payments to such bogus creditor. How will you deal as an auditor?
- (b) Auditor of A Ltd while conducting audit in the course of the performance of his duties as auditor, believes with reasons that "an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed". Analyse and also explain the manner of reporting the matter to the Central Government.
19. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required.
20. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.
21. According to section 134(3)(c) of the Companies Act, 2013, the report of board of directors on annual accounts shall also include a 'Director's Responsibility Statement'. Explain.

Chapter 9- Audit of Different Types of Entities

22. (a) An audit of Expenditure is one of the major components of Government Audit. In the context of 'Government Expenditure Audit', write in brief, what do you understand by:
- (i) Audit against Rules and Orders
 - (ii) Audit of Sanctions
 - (iii) Audit against Provision of Funds
 - (iv) Propriety Audit
 - (v) Performance Audit.
- (b) Explain in detail the duties of Comptroller and Auditor General of India.

SUGGESTED ANSWERS / HINTS

MULTIPLE CHOICE QUESTIONS- Integrated Case Scenario-1

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

MULTIPLE CHOICE QUESTIONS- Integrated Case Scenario-2

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

General MCQ's

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

DESCRIPTIVE ANSWERS

1. (i) **Incorrect:** all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more shall constitute an Audit Committee.
- (ii) **Incorrect:** According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014.
- (iii) **Incorrect:** As per sub-section (5) of the section 140, the Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the

company or its directors or officers, it may, by order, direct the company to change its auditors.

- (iv) **Incorrect:** SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.
- (v) **Incorrect:** Government audit serves as a mechanism or process for public accounting of government funds. It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.
- (vi) **Correct:** The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion.
- (vii) **Incorrect:** The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor as to whether the financial statements exhibit a true and fair view of the affairs of the entity.

Thus, an Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent.

- (viii) **Incorrect:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

In case of difference of opinion, either the auditor will issue qualified report or adverse report and not disclaimer of opinion.

- (ix) **Incorrect:** Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.
 - (x) **Incorrect:** Risk assessment procedures refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
2. (a) "An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Analysis of the Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements.

The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

- (i) the accounts have been drawn up with reference to entries in the books of account;
 - (ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;
 - (iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;
 - (iv) the information conveyed by the statements is clear and unambiguous;
 - (v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
 - (vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.
- (b) As per SA-200 “Overall Objectives of the Independent Auditor”, in conducting an audit of financial statements, the overall objectives of the auditor are:
- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and
 - (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor’s findings.
3. (a) **The Nature of Audit Procedures:** There are practical and legal limitations on the auditor’s ability to obtain audit evidence. For example:
1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
 2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example,

collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(b) **Other Matters that Affect the Limitations of an Audit:** In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

4. **Discrepancies in the accounting records, including:**

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

5. (a) **Positive confirmation request** – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

- (b) When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:
 - (a) Determining the information to be confirmed or requested;
 - (b) Selecting the appropriate confirming party;
 - (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
 - (d) Sending the requests, including follow-up requests when applicable, to the confirming party.
- 6. (a) **Plans should be further developed and revised as necessary during the course of the audit.**

SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

- (b) **Overall audit strategy** sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
2. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
3. When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
4. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (**for example, on-site or off-site**), and whether to complete engagement quality control reviews.

7. (a) Examples are :

- ◆ The competitive environment, including demand, capacity, product and price competition as well as cyclical or seasonal activity.
- ◆ Supplier and customer relationships, such as types of suppliers and customers (e.g., related parties, unified buying groups) and the related contracts with those entities.
- ◆ Technological developments, such as those related to the entity's products, energy supply and cost.
- ◆ The effect of regulation on entity operations.

- (b)** Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

Example**Sales are evidenced by:**

- (i) invoices raised by the client;
- (ii) price list;
- (iii) forwarding notes to client;
- (iv) inventory-issue records;
- (v) sales managers' advice to the inventory section;
- (vi) acknowledgements of the receipt of goods by the customers; and
- (vii) collection of money against sales by the client.

- 8.** Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations

does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

The objectives of the auditor regarding written representation

The objectives of the auditor are:

- (a) **To obtain written representations:** To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
 - (b) **To support other evidence:** To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and
 - (c) **To respond appropriately:** To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.
9. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

10. **Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Example

Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

11. (a) **Control risk assessment when control deficiencies are identified:** When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.

When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested. If auditor determines that they support a 'rely on controls' risk assessment, or if compensating controls are identified, tested and evaluated to be effective, he may conclude that the 'rely on controls' is still appropriate. Otherwise we change our control risk assessment to 'not rely on controls.'

When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to 'not rely on controls' for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion. If the deficiency relates to one WCGW (what can go wrong) out of several WCGW's, he can 'rely on controls' but performs additional substantive procedures to adequately address the risks related to the deficiency.

- (b) Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:
- ◆ Assessing risks of material misstatement of the financial statements;
 - ◆ Determining materiality in accordance with SA 320;
 - ◆ Considering the appropriateness of the selection and application of accounting policies;
 - ◆ Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
 - ◆ Developing expectations for use when performing analytical procedures;
 - ◆ Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

12. (a) **Objectives of Internal Control:** Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.
- (i) transactions are executed in accordance with managements general or specific authorization;
 - (ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
 - (iii) assets are safeguarded from unauthorised access, use or disposition; and
 - (iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.
- (b) It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows.

Example

For example, the procedure for sales requires the following:

1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.
4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.

5. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honoured its commitments in the past.
13. Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS).

A financial statement audit comprises the examination of an entity's financial statements and accompanying disclosures by an independent auditor. The result of this examination is a report by the auditor, attesting to the truth and fairness of presentation of the financial statements and related disclosures.

In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding:

- completeness;
- cut-off;
- existence/ occurrence;
- valuation/ measurement;
- rights and obligations; and
- presentation and disclosure

of assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards.

Example

If Company X's balance sheet shows building with carrying amount of ₹ 50 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end (existence assertion);
 - Company X owns and controls such building (Rights and obligations assertion);
 - The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
 - All buildings owned and controlled by Company X are included within the carrying amount of ₹ 50 lakh (Completeness assertion).
14. **Meaning of Valuation Assertion**– Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Example of Inventory explaining the valuation assertion is given hereunder:

Inventory has been recognized at the lower of cost and net realizable value in accordance with AS 2 - Inventories. Any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (eg. FIFO, Weighted average etc.) has been used to value inventory as at the period-end.

15. (a) Receipt of Capital Subsidy:

- (i) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.
- (ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.
- (iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
- (iv) Check relevant entries for receipt of subsidy.
- (v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for and also complies with the disclosure requirements.

(b) Verification of Cash at Bank: While testing the authenticity of cash at bank, the following areas may be considered by the auditor-

- (i) Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book.
- (ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.
- (iii) 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.
- (iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.
- (v) The auditor should examine 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.
- (vi) 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.

- (vii) 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.
- (viii) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.
- (ix) 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.
- (x) 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.

(c) Sales Commission Expenditure:

- (i) Ascertain agreement, if any, in respect of sales transaction actually occurred during the year carried out by authorized parties on its behalf. If yes, the commission should be in accordance with the terms and conditions as specified.
- (ii) Check evidence of services rendered by the party to whom commission is paid with reference to correspondence etc.
- (iii) Ensure that the sales in fact have taken place and the same has been charged to Statement of Profit and Loss.
- (iv) Compare the amount incurred in previous years with reference to total turnover.
- (v) Check entries regarding TDS on commission at the time of credit to Payee's Account, or payment, whichever is earlier.
- (vi) Ensure that the payment has been made through cheque only, if limit as stated in the clause of tax audit is exceeded.

(d) Advances to the Suppliers:

- (i) Obtain schedule of debit balances in trade payables' account and pay particular attention to the age of the balances. Also, scrutinise the bought ledger by tracing the corresponding entries in the cash/bank book.
- (ii) Enquiry should be made for long unadjusted outstanding and check as to

whether any of them would require provisioning.

- (iii) Examine that the advances have not been shown as deposits in balance sheet as per Section 143(1) of the Companies Act, 2013.
 - (iv) Confirmation of balances should be obtained and reconciliation be done in case of any discrepancies.
 - (v) Assess the possibility of delivery of goods against advance payment and examine whether provisioning is required.
 - (vi) Ensure proper classification in the Balance sheet as per requirement of Schedule III to the Companies Act, 2013
- 16.** Further, sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:
- It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.
- Further as **per rule 12 of the Companies (Audit and Auditors) Rules, 2014**, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.
- 17. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:**
- (a) identify division of audit areas and common audit areas;
 - (b) ascertain the reporting objectives of the engagement;
 - (c) consider and communicate among all joint auditors the factors that are significant
 - (d) in directing the engagement team's efforts;
 - (e) consider the results of preliminary engagement activities, or similar engagements performed earlier.

- (f) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.
18. (a) Here, the auditor of the company is required to report the fraudulent activity to the Board or Audit Committee (as the case may be) within 2 days of his knowledge of fraud. Further, the company is also required to disclose the same in Board's Report. It may be noted that the auditor need not to report the central government as the amount of fraud involved is less than ₹ 1 crore, however, reporting under CARO, 2016 is required.
- (b) **Reporting to the Central Government:** As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

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

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

- (a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;
- (b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;
- (c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;
- (d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

- (e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
 - (f) the report shall be in the form of a statement as specified in Form ADT-4.
19. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:
- (i) The selective correction of misstatements brought to management's attention during the audit.

Example

- ◆ Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
 - ◆ The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.
- (ii) Possible management bias in the making of accounting estimates.
20. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."
- The Opinion section of the auditor's report shall also:
- (a) Identify the entity whose financial statements have been audited;
 - (b) State that the financial statements have been audited;
 - (c) Identify the title of each statement comprising the financial statements;
 - (d) Refer to the notes, including the summary of significant accounting policies; and
 - (e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

21. **Director's Responsibility Statement:** According to section 134(3)(c) of the Companies Act, 2013, the report of board of directors on annual accounts shall also include a 'Director's Responsibility Statement'. However, the provisions related to Director's Responsibility Statement are provided under section 134(5) of the Companies Act, 2013 which requires to state that-

- (i) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;
 - (ii) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;
 - (iii) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
 - (iv) the directors had prepared the annual accounts on a going concern basis;
 - (v) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.
 - (vi) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.
- 22. (a) Government Expenditure Audit:** Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. **Briefly, these standards are explained below:**
- (i) **Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.
 - (ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.
 - (iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.
 - (iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.
 - (v) **Performance Audit:** This involves that the various programmes, schemes and

projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

(b) Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under-

- (i) **Compile and submit Accounts of Union and States** - The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.
- (ii) **General Provisions Relating to Audit - It shall be the duty of the C&AG –**
 - (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;
 - (b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
 - (c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.
- (iii) **Audit of Receipts and Expenditure** - Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.
- (iv) **Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable

previous notice, to the books and accounts of that authority or body.

- (v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.
- (vi) **Audit of Accounts of Stores and Inventory** - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.
- (vii) **Audit of Government Companies and Corporations** - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

PAPER – 7: INFORMATION TECHNOLOGY AND STRATEGIC MANAGEMENT

SECTION – A: INFORMATION TECHNOLOGY

QUESTIONS

Multiple Choice Questions

Questions No.(s) 1 to 3 are based on Case Scenario

XYZ is a handbag manufacturing company which was established in year 2010 in India. It had good sales record through its factory outlets as well as online through the mobile app throughout the country. However, sometime before, the management realized that there has been an exponential fall in the sales of its products. To identify the causes of decline in the sales, the top management used a structured approach of ongoing refinement in response to continuous feedback provided by its customers. They created the database of their valuable customers throughout the country and sought their feedback either in physical mode or digital mode through a feedback form and started analyzing each suggestion(s) and comment(s) provided by their customers.

Issues highlighted through Feedback Form were -

- (a) Zips used in handbags were not of good quality.
- (b) Customers wanted the customized product of their own choice.
- (c) The designs of the handbags were obsolete.

Based on the above case scenario, answer the following questions:

1. Through Feedback Form, the top management of XYZ company identified the reasons for the decline in the sales of its handbags. Which of the following information system would have been used to capture and analyze the feedback of the customers?
 - (a) Management Information System
 - (b) Decision Support System
 - (c) Legal Management software
 - (d) Knowledge Management System
2. In purview of above case scenario, what do you think the approach will be followed by the Top management of XYZ company to improve the quality of their products?
 - (a) Total Quality Management
 - (b) Business Process Automation
 - (c) Six Sigma

- (d) Process Management
- 3. The customers of XYZ company need to register themselves to buy any product through mobile app. To do so, they have to follow certain steps for authentication process. Which of the following control is used to fulfill this purpose?
 - (a) Output Control
 - (b) Input Control
 - (c) Database Control
 - (d) Boundary Control
- 4. Internet users access Google App Engine that allows them to run their web applications on Google's Infrastructure. Which of the following service model of cloud computing does this feature belong to?
 - (a) Platform as a Service
 - (b) Network as a Service
 - (c) Communication as a Service
 - (d) Software as a Service
- 5. Huge volume of data is being exchanged on internet, so the security of networks on internet must be robust. Which of the following is not considered as the key aspect of security in network?
 - (a) Confidentiality
 - (b) Threat Identification
 - (c) Message Authentication
 - (d) Message Integrity

Descriptive Questions

Chapter 1: Business Process Management & IT

- 6. Business Process Management (BPM) is used to improve products and services through structured approach to performance improvement. Explain the principles on which BPM works.
- 7. Mr. R is an accountant who has recently joined an organization ABC. His senior has provided him the documents through which he is supposed to build a logical understanding of how the processing of complex tasks takes place in organisation ABC. In the absence of proper documentation, it would have been a herculean task for Mr. R to comprehend the

working or various processes in ABC. Keeping this in mind, comment upon the importance of documentation to Information Systems in an organization.

Chapter 2: Information Systems and IT Fundamentals

8. Nowadays, Cloud computing is one of the emerging technologies used by most of the companies, as it provides various benefits depending upon the need of the user through its different types of clouds. Discuss these different types of cloud offered by Cloud Computing.
9. Describe the areas in which risks and controls have been affected by IT within organization.

Chapter 3: Telecommunication and Networks

10. Differentiate between Centralized Computing and Decentralized Computing.
11. XYZ Company wishes to open its new branches at different locations within the same city. As the IT head of the company, Mr. A needs to highlight network security related threats in his presentation to top management. What would be the content of presentation of Mr. A?

Chapter 4: Business Information systems

12. Describe all the components of Accounting Information System (AIS) that results in statistical reports that can be used internally by management and externally by other interested parties.
13. In an organization, Access controls help to restrict whom and what accesses the information resources. What are the functions of access control that work together to grant access to resources and constrain what a subject can do with them?

Chapter 5: Business Process Automation through Application Software

14. ABC is a Software development company which are using certain controls to protect the integrity of their database when application software acts as an interface to interact between the user and the database. Identify the Control and explain its detailed functions.
15. XYZ is a Central university with many colleges affiliated under it. The university and the colleges have huge infrastructure in terms of computers, printers, wi-fi, smart labs etc. However, these resources remain under-utilized most of the time. Therefore, to make use of non-utilized computing power of various computing resources in an effective manner, it was decided by top management of university to share computing power of underutilized resources with needy organizations. Which technology is top management referring to? Describe the characteristics of that technology.

SUGGESTED ANSWERS/HINTS

Multiple Choice Answers

1. (a) Management Information System
2. (a) Total Quality Management
3. (d) Boundary Control
4. (a) Platform as a Service
5. (b) Threat Identification

Descriptive Answers

6. The Principles of Business Process Management (BPM) are as follows:
 1. BPM's first principle is **processes are assets** that create value for customers. They are to be managed and continuously improved. Because processes are assets, core processes and processes that generate the most value to customers should be carefully managed.
 2. A managed process produces consistent **value to customers** and has the foundation for the process to be improved. Management of processes entails the tasks of measuring, monitoring, controlling, and analyzing business processes. Measuring of business processes provides information regarding these business processes. Process information allows organizations to predict, recognize, and diagnose process deficiencies, and it suggests the direction of future improvements.
 3. The third principle is **continuous improvement** of processes. This is a natural result of process management. Process improvement is facilitated by the availability of process information. The business environment usually dictates that organizations need to improve to stay competitive. Business processes are central to an organization's value creation. It follows that processes should be continuously improved.
7. The reasons why documentation is important to Information Systems are as follows:
 - (a) **Depicting how the system works:** In computerized systems, the processing is electronic and invisible. Therefore, documentation is required to help employees understand how a system works, assist accountants in designing controls for it, demonstrates to managers that it will meet their information needs, and assists auditors in understanding the systems that they test and evaluate.
 - (b) **Training users:** Documentation also includes user guides, manuals, and similar operating instructions that help people learn how an Information System operates.

These documentation aids help train users to operate Information systems hardware and software, solve operational problems, and perform their jobs better.

- (c) **Designing new systems:** Documentation helps system designers develop new systems in much the same way that blueprints help architects design building. Well-written documentation and related graphical systems-design methodologies play key roles in reducing system failures and decreasing the time spent correcting emergency errors.
 - (d) **Controlling system development and maintenance costs:** Personal computer applications typically employ prewritten, off-the-shelf software that is relatively reliable and inexpensive. Good documentation helps system designers develop object-oriented software, which is software that contains modular, reusable code that further avoid writing duplicate programs and facilitate changes when programs must be modified later.
 - (e) **Standardizing communications with others:** Documentation aids such as E-R Diagrams, System Flowcharts, and Data Flow Diagrams are more standardized tools, and they are more likely to be interpreted the same way by all parties viewing them. Thus, documentation tools are important because they help describe an existing or proposed system in a common language and help users communicate with one another about these systems.
 - (f) **Auditing Information Systems:** Documentation helps depict audit trails. For example- when investigation and Accounting Information system, the auditors typically focus on internal controls. In such circumstances, documentation helps auditors determine the strengths and weaknesses of a system's controls and therefore the scope and complexity of the audit.
 - (g) **Documenting business processes:** Understanding business processes can lead to better systems and better decision. Documentation helps managers better understand how their businesses operate what controls are involved or missing from critical organizational activities, and how to improve core business activities.
8. The different types of cloud used by organization are as follows:
- **Public Clouds:** The public cloud is made available to the general public or a large industry group. They are administrated by third parties or vendors over the Internet, and services are offered on pay-per-use basis. The key benefits are as follows:
 - (a) It is widely used in the development, deployment and management of enterprise applications, at affordable costs;

(b) It allows organizations to deliver highly scalable and reliable applications rapidly and at more affordable costs.

- **Private Clouds:** This cloud computing environment resides within the boundaries of an organization and is used exclusively for the organization's benefits. These are also called internal clouds. They are built primarily by IT departments within enterprises who seek to optimize utilization of infrastructure resources within the enterprise by provisioning the infrastructure with applications using the concepts of grid and virtualization. The benefit of a Private Cloud is that it enables an enterprise to manage the infrastructure and have more control, but this comes at the cost of IT department creating a secure and scalable cloud.
- **Community Clouds:** This is the sharing of computing infrastructure in between organizations of the same community. For example, all Government organizations within India may share computing infrastructure on the cloud to manage data. The risk is that data may be stored with the data of competitors.
- **Hybrid Clouds:** It is maintained by both internal and external providers. It is a composition of two or more clouds (Private, Community or Public). They have to maintain their unique identity, but are bound together by standardized data and application portability. With a hybrid cloud, organizations might run non-core applications in a public cloud, while maintaining core applications and sensitive data in-house in a private cloud.

9. The impact of IT on Risks within an organization are as follows:

- ◆ Ready access to terminals as computerized Information Systems are highly distributed and leads to ease in perpetration of computer related crimes thereby increasing temptation for abuse.
- ◆ On-line processing of data and validation checks would help the prospective perpetrator in guessing passwords and aid in circumventing controls in inputs to computer.
- ◆ Appropriate controls are not resident within the computer systems to detect or to prevent the accidents. If threats are not anticipated and adequate controls are not designed to mitigate or counter them, system and its resources will be vulnerable.
- ◆ The greatest exposure of all is a failure to recognize risks or potential impacts of those risks. Prudence demands that contingencies are to be anticipated and planning done to handle them.

The major areas in which controls have been affected by IT are as follows:

- ◆ **Realignment of functions:** Data entry and source of transactions may be centralized;

- ◆ **Changes in custody of files and documents:** Ready access to data over telecom links complicate custodial functions of data. Data librarian may become in charge for data;
- ◆ **Transfer of responsibilities:** Single action by user may complete the entire processing cycle of the transaction; and
- ◆ **Decline of accountability:** Traditional functions, responsibilities and boundaries have been eliminated or are obscured by new methods.

10. **Centralized Computing:** Centralized computing is computing done at a central location, using terminals that are attached to a central computer. The computer itself may control all the peripherals directly or they may be attached via a terminal server. It offers greater security over decentralized systems because all the processing is controlled in a central location. In addition, if one terminal breaks down, the user can simply go to another terminal and log in again, and all their files will still be accessible. Depending on the system, they may even be able to resume their session from the point they were at before, as if nothing had happened.

This type of arrangement does have some disadvantages.

- The central computer performs the computing functions and controls the remote terminals. This type of system relies totally on the central computer. Should the central computer crash, the entire system will "go down" (i.e. will be unavailable).
- Central computing relies heavily on the quality of administration and resources provided to its users. Should the central computer be inadequately supported by any means, then the usage will suffer greatly.

Decentralized Computing: Decentralized computing is the allocation of resources, both hardware and software, to each individual workstation, or office location. In contrast, centralized computing exists when the majority of functions are carried out, or obtained from a remote centralized location. A collection of decentralized computers systems are components of a larger computer network, held together by local stations of equal importance and capability. These systems are capable of running independently of each other. Decentralized systems enable file sharing and all computers can share peripherals such as printers and scanners as well as modems, allowing all the computers in the network to connect to the internet.

11. Network security threats can be categorized into four broad themes:

- ◆ **Unstructured Threats** - These originate mostly from inexperienced individuals using easily available hacking tools from the Internet. Many tools available to anyone on the Internet can be used to discover weaknesses in a company's network. These

include port-scanning tools, address-sweeping tools, and many others. Most of these kinds of probes are done more out of curiosity than with a malicious intent in mind.

For example, if a company's external web site is hacked; the company's integrity is damaged. Even if the external web site is separate from the internal information that sits behind a protective firewall, the public does not know that. All they know is that if the company's web site is hacked, then it is an unsafe place to conduct business.

- ◆ **Structured Threats** - These originate from individuals who are highly motivated and technically competent and usually understand network systems design and the vulnerabilities of those systems. They can understand as well as create hacking scripts to penetrate those network systems. An individual who presents a structured threat typically targets a specific destination or group. Usually, these hackers are hired by industry competitors, or state-sponsored intelligence organizations.
- ◆ **External Threats** - These originate from individuals or organizations working outside an organization, which does not have authorized access to organization's computer systems or network. They usually work their way into a network from the Internet or dialup access servers.
- ◆ **Internal Threats** - Typically, these threats originate from individuals who have authorized access to the network. These users either have an account on a server or physical access to the network. An internal threat may come from a discontented former or current employee or contractor. It has been seen that majority of security incidents originate from internal threats.

12 The key components of Accounting Information System are as follows:

- **People:** AIS helps various system users that include accountants, consultants, business analysts, managers, chief financial officers and auditors etc. from different departments within a company to work together. With well-designed AIS, everyone within an organization who is authorized to do so can access the same system and get the same information. AIS also simplify getting information to people outside of the organization when necessary.
- **Procedure and Instructions:** These include both manual and automated methods for collecting, storing, retrieving and processing data.
- **Data:** This refers to the information pertinent to the organization's business practices that may include sales orders, customer billing statements, sales analysis reports, purchase requisitions, vendor invoices, check registers, general ledger, inventory data, payroll information, timekeeping, tax information etc. This data can then be used to prepare accounting statements and reports such as accounts receivable aging, depreciation/ amortization schedules, trial balance, profit and loss, and so on.
- **Software:** These are the computer programs that provide quality, reliability and security to the company's financial data that may be stored, retrieved, processed and

analyzed. Managers rely on the information it outputs to make decisions for the company, and they need high-quality information to make sound decisions.

- **Information Technology Infrastructure:** This includes hardware such as personal computers, servers, printers, surge protectors, routers, storage media, and possibly a backup power supply used to operate the system. The hardware selected for AIS must be compatible with the intended software.
 - **Internal Controls:** These are the security measures such as passwords or as complex as biometric identification to protect sensitive data against unauthorized computer access and to limit access to authorized users. Internal controls also protect against computer viruses, hackers and other internal and external threats to network security.
13. The following functions work together to grant access to resources and constrain what a subject can do with them.
- ◆ **Identity Management:** Identity management consists of one or more processes to verify the identity of a subject attempting to access an object. However, it does not provide 100 percent assurance of the subject's identity. Rather, it provides a level of probability of assurance. The level of probability depends on the identity verification processes in place and their general trustworthiness. Identity management has become a separate consideration for access control. However, the three pillars that support authorized access still define the tools and techniques necessary to manage who gets access to what and what they can do when they get there: authentication, authorization, and accountability.
 - ◆ **Authentication:** Identity management and authentication are inseparable. Identity management includes assigning and managing a subject's identity. Authentication is the process of verifying a subject's identity at the point of object access.
 - ◆ **Authorization:** Once a resource or network verifies a subject's identity, the process of determining what objects that subject can access, begins. Authorization identifies what systems, network resources, etc. a subject can access. Related processes also enforce least privilege, need-to-know, and separation of duties. Authorization is further divided into coarse and fine dimensions.
 - ◆ **Accountability:** Each step from identity presentation through authentication and authorization is logged. Further, the object or some external resource logs all activity between the subject and object. The logs are stored for audits, sent to a log management solution, etc. They provide insight into how well the access control process is working: whether or not subjects abuse their access.
14. **Database Controls** under Application Controls are the controls that protect the integrity of their database when application software acts as an interface to interact between the user and the database. The functions of Database Controls are as follows:

- **Sequence Check Transaction and Master Files:** Synchronization and the correct sequence of processing between the master file and transaction file is critical to maintain the integrity of updation, insertion or deletion of records in the master file with respect to the transaction records. If errors in this stage are overlooked, it leads to corruption of the critical data.
- **Ensure all records on files are processed:** While processing the transaction file records mapped to the respective master file the end-of-file of the transaction file with respect to the end-of-file of the master file is to be ensured.
- **Process multiple transactions for a single record in the correct order:** Multiple transactions can occur based on a single master record. For example, dispatch of a product to different distribution centers. The order in which transactions are processed against the product master record must be done based on a sorted transaction codes.

15 The technology referred by top management of XYZ University is **Grid Computing**.

The Characteristics of Grid Computing are as follows:

- **Making use of Underutilized Resources:** In most organizations, there are large amounts of underutilized computing resources. In some organizations, even the server machines can often be relatively idle. Grid computing provides a framework for exploiting these underutilized resources and thus has the possibility of substantially increasing the efficiency of resource usage. Grid computing (more specifically, a data grid) can be used to aggregate this unused storage into a much larger virtual data store, possibly configured to achieve improved performance and reliability over that of any single machine.
- **Resource Balancing:** For applications that are grid-enabled, the grid can offer a resource balancing effect by scheduling grid jobs on machines with low utilization. This feature of grid computing handles occasional peak loads of activity in parts of a larger organization. An unexpected peak can be routed to relatively idle machines in the grid; and if the grid is already fully utilized, the lowest priority work being performed on the grid can be temporarily suspended or even cancelled and performed again later to make room for the higher priority work.
- **Parallel CPU Capacity:** The potential for usage of massive parallel CPU capacity is one of the most common visions and attractive features of a grid. A CPU-intensive grid application can be thought of as many smaller sub-jobs, each executing on a different machine in the grid. To the extent that these sub-jobs do not need to communicate with each other, the more scalable the application becomes. A perfectly scalable application will, for example, finish in one tenth of the time if it uses ten times the number of processors

- **Virtual resources and virtual organizations for collaboration:** Another capability enabled by grid computing is to provide an environment for collaboration among a wider audience. The users of the grid can be organized dynamically into a number of virtual organizations, each with different policy requirements. These virtual organizations can share their resources such as data, specialized devices, software, services, licenses, and so on, collectively as a larger grid. These resources are virtualized to give them a more uniform interoperability among heterogeneous grid participants. The participants and users of the grid can be members of several real and virtual organizations. The grid can help in enforcing security rules among them and implement policies, which can resolve priorities for both resources and users.
- **Access to additional resources:** In addition to CPU and storage resources, a grid can provide access to other resources as well. For example, if a user needs to increase their total bandwidth to the Internet to implement a data mining search engine, the work can be split among grid machines that have independent connections to the Internet. In this way, total searching capability is multiplied, since each machine has a separate connection to the Internet. Some machines may have expensive licensed software installed that users require. Users' jobs can be sent to such machines, more fully exploiting the software licenses. Some machines on the grid may have special devices. All of these will make the grid look like a large system with a collection of resources beyond what would be available on just one conventional machine.
- **Reliability:** High-end conventional computing systems use expensive hardware to increase reliability. The machines also use duplicate processors in such a way that when they fail, one can be replaced without turning the other off. Power supplies and cooling systems are duplicated. The systems are operated on special power sources that can start generators if utility power is interrupted. All of this builds a reliable system, but at a great cost, due to the duplication of expensive components.
- **Management:** The goal to virtualize the resources on the grid and more uniformly handle heterogeneous systems create new opportunities to better manage a larger, more distributed IT infrastructure. The grid offers management of priorities among different projects. Aggregating utilization data over a larger set of projects can enhance an organization's ability to project future upgrade needs. When maintenance is required, grid work can be rerouted to other machines without crippling the projects involved.

SECTION – B: STRATEGIC MANAGEMENT

Multiple Choice Questions

1. In the questions given below select the best answer out of options (A), (B), (C), or (D):
 - (a) Consider following statements?
 - i. Opportunity helps an organisation to consolidate and strengthen its position.
 - ii. Stiff competition is opportunity.
 - iii. Growing demand for the product is opportunity.Which of the above statements are true?
 - A. i. and ii.
 - B. ii.and iii.
 - C. i. and iii.
 - D. i., ii. and iii
 - (b) If there is increase in number of units buying products from a single supplier, then –
 - A. Bargaining power of supplier will reduce.
 - B. There will be no change in bargaining for the supplier.
 - C. Bargaining power of buyer company will increase.
 - D. Bargaining power of buyer company will reduce.
 - (c) Strategic management leads organisations to become _____ in shaping future.
 - A. Mechanical
 - B. Proactive
 - C. Sensitive
 - D. Uncertain
 - (d) Goals are _____ attributes that are expressed in specific terms.
 - A. close-ended
 - B. control
 - C. profitable
 - D. useful

- (e) Key success factors:
- A. Are ignored by a profitable business
 - B. Are insignificant force
 - C. Change over time
 - D. Remain same within an industry.
- (f) Efficiency curve explains the efficiency _____ gained by workers through _____ work
- A. Improvement, random
 - B. Increase, efficient
 - C. Increase, repetitive
 - D. Increase, variable
- (g) Stability strategy is adopted when:
- i. It is less risky and found to be comfortable
 - ii. The environment faced is highly volatile.
 - iii. Expansion is perceived as being threatening.
- Which of the above statements are true?
- A. i. and ii.
 - B. ii. and iii.
 - C. i. and iii.
 - D. i., ii. and iii
- (h) Two unrelated businesses joining together to form a new undertaking is a case of:
- A. Co-generic merger:
 - B. Conglomerate merger:
 - C. Horizontal merger:
 - D. Horizontal Diversification
- (i) A market-coverage strategy that involves going after a large share of one or few sub-markets is:
- A. Augmented Marketing
 - B. Concentrated Marketing
 - C. Direct Marketing

- D. Place Marketing
- (j) Technological improvements that affect company products, _____ product life cycle.
- A. economises
 - B. improves
 - C. increase
 - D. shorten
- (k) Network structure involves virtual _____ of in house business functions
- A. concentration
 - B. differentiation
 - C. elimination
 - D. expansion
- (l) Value Chain connects:
- A. All the activities within an organisation
 - B. An organisation with competitors
 - C. Finance function with other functional areas of business
 - D. Internal and external activities from suppliers to buyers of product
- (m) Benchmarking:
- A. involves copying best practices in industry
 - B. involves learning and adapting best practices in industry
 - C. is a process of one time improvement
 - D. is a solution to all organisational problems
- (n) V in DMADV (acronym for steps in implementing six sigma for designing new products) represents:
- A. Variety
 - B. Value
 - C. Verify
 - D. Virtual
2. Distinguish between the following
- (a) Economic environment and Socio-cultural environment.

- (b) Divestment strategy and Liquidation strategy.
 - (c) Concentric diversification and conglomerate diversification.
 - (d) Transformational and transactional leadership
3. Write short note on:
- (a) Socio-cultural environment
 - (b) Premise control
 - (c) Environmental Scanning
 - (d) Market Development
 - (e) Key success factors
 - (f) Strategic surveillance

Chapter 1-Business Environment

4. "Porter's five forces model systematically diagnoses the significant competitive pressures in a market". Discuss.
5. Explain how organisation may respond to environmental changes.

Chapter 2-Business Policy and Strategic Management

6. What do you understand by strategic management? Discuss its framework.
7. What tips can you offer to write a 'right' Mission Statements?

Chapter 3-Strategic Analysis

8. Discuss stop light strategy model.
9. Discuss various issues in analysis of competition in an industry?

Chapter 4-Strategic Planning

10. What are different strategic bases on which an existing firm can diversify?
11. Devise an ideal work plan for implementing a turnaround strategy in an organization?

Chapter 5-Formulation of Functional Strategy

12. What is meant by Functional strategies? In term of level where will you put them? Are functional strategies really important for business?
13. What are the objectives that must be kept in mind while designing a pricing strategy of a new product?

Chapter 6-Strategic Implementation and Control

14. An important part of strategic management process is implementation of strategy. Discuss the relationship of soundness of strategy formulation with the quality of implementation.

15. Define corporate culture. Also elucidate the statement “Culture is a strength that can also be a weakness”.

Chapter 7-Reaching Strategic Edge

16. Compare the Traditional Management Practices with Total Quality Management (TQM).
17. “Many organisations are adopting six sigma tools for improvement”. Discuss how six sigma helps business organizations.

SUGGESTED ANSWER

1. Multiple Choice Questions

- | | | |
|---------|---------|---------|
| (a) (C) | (f) (C) | (k) (C) |
| (b) (D) | (g) (C) | (l) (D) |
| (c) (B) | (h) (B) | (m) (B) |
| (d) (A) | (i) (B) | (n) (C) |
| (e) (C) | (j) (D) | |

2. (a) The economic environment refers to the nature and direction of the economy in which a company competes or may compete. It includes general economic situation in the region and the nation, conditions in resource markets which influence the supply of inputs to the enterprise, their costs, quality, availability and reliability of supplies.

Economic environment determines the strength and size of the market. The purchasing power in an economy depends on current income, prices, savings, circulation of money, debt and credit availability. Income distribution pattern determines the marketing possibilities. The important point to consider is to find out the effect of economic prospect and inflation on the operations of the firms. Strategists must scan, monitor, forecast, and assess a number of key economic factors for both domestic and key international markets.

Socio-Cultural Environment influences almost all enterprises in a similar manner. It primarily affects strategic management process within the organization in the areas of mission & objectives setting and decisions related to products & markets.

Socio-cultural environment is a complex combination of factors such as social traditions, values and beliefs, changing lifestyle patterns & materialism, level and standards of literacy and education, awareness & consciousness of rights and work ethics of members of society, the ethical standards and state of society, the extent of social stratification, conflict and cohesiveness, social concerns such as corruption, environmental pollution etc.

- (b) **Divestment Strategy:** Divestment strategy involves the sale or liquidation of a portion of business, or a major division, profit centre or SBU. Divestment is usually a part of rehabilitation or restructuring plan and is adopted when a turnaround has been attempted but has proved to be unsuccessful. The option of a turnaround may even be ignored if it is obvious that divestment is the only answer.

Liquidation Strategy: Liquidation as a form of retrenchment strategy is considered as the most extreme and unattractive. It involves closing down a firm and selling its assets. It is considered as the last resort because it leads to serious consequences such as loss of employment for workers and other employees, termination of opportunities a firm could pursue, and the stigma of failure.

- (c) Concentric diversification occurs when a firm adds related products or markets. On the other hand conglomerate diversification occurs when a firm diversifies into areas that are unrelated to its current line of business.

In concentric diversification, the new business is linked to the existing businesses through process, technology or marketing. In conglomerate diversification, no such linkages exist; the new business/product is disjointed from the existing businesses/products.

The most common reasons for pursuing a concentric diversification are that opportunities in a firm's existing line of business are available. However, common reasons for pursuing a conglomerate growth strategy is that opportunities in a firm's current line of business are limited or opportunities outside are highly lucrative.

- (d) **Transformational leadership style** use charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leadership style may be appropriate in turbulent environments, in industries at the very start or end of their life-cycles, in poorly performing organizations when there is a need to inspire a company to embrace major changes. Transformational leaders offer excitement, vision, intellectual stimulation and personal satisfaction. They inspire involvement in a mission, giving followers a 'dream' or 'vision' of a higher calling so as to elicit more dramatic changes in organizational performance. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self-confidence, and also promote innovation throughout the organization.

Whereas, **transactional leadership style** focus more on designing systems and controlling the organization's activities and are more likely to be associated with improving the current situation. Transactional leaders try to build on the existing culture and enhance current practices. Transactional leadership style uses the authority of its office to exchange rewards, such as pay and status. They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement.

Transactional leadership style may be appropriate in settled environment, in growing or mature industries, and in organizations that are performing well. The style is better suited in persuading people to work efficiently and run operations smoothly.

3. (a) Socio-cultural environment consist of factors related to human relationships and the impact of social attitudes and cultural values which has bearing on the business of the organization. The beliefs, values and norms of a society determine how individuals and organizations should be interrelated. The core beliefs of a particular society tend to be persistent. It is difficult for businesses to change these core values, which becomes a determinant of its functioning.
- (b) A strategy is formed on the basis of certain assumptions or premises about the complex and turbulent organizational environment. Over a period of time these premises may not remain valid. Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built. It primarily involves monitoring two types of factors:
 - (i) Environmental factors such as economic (inflation, liquidity, interest rates), technological, social, legal and regulatory factors.
 - (ii) Industry factors such as competitors, suppliers, substitutes.

It is neither feasible nor desirable to control all types of premises in the same manner. Different premises may require different amount of control. Thus, managers are required to select those premises that are likely to change and would severely impact the functioning of the organization and its strategy.

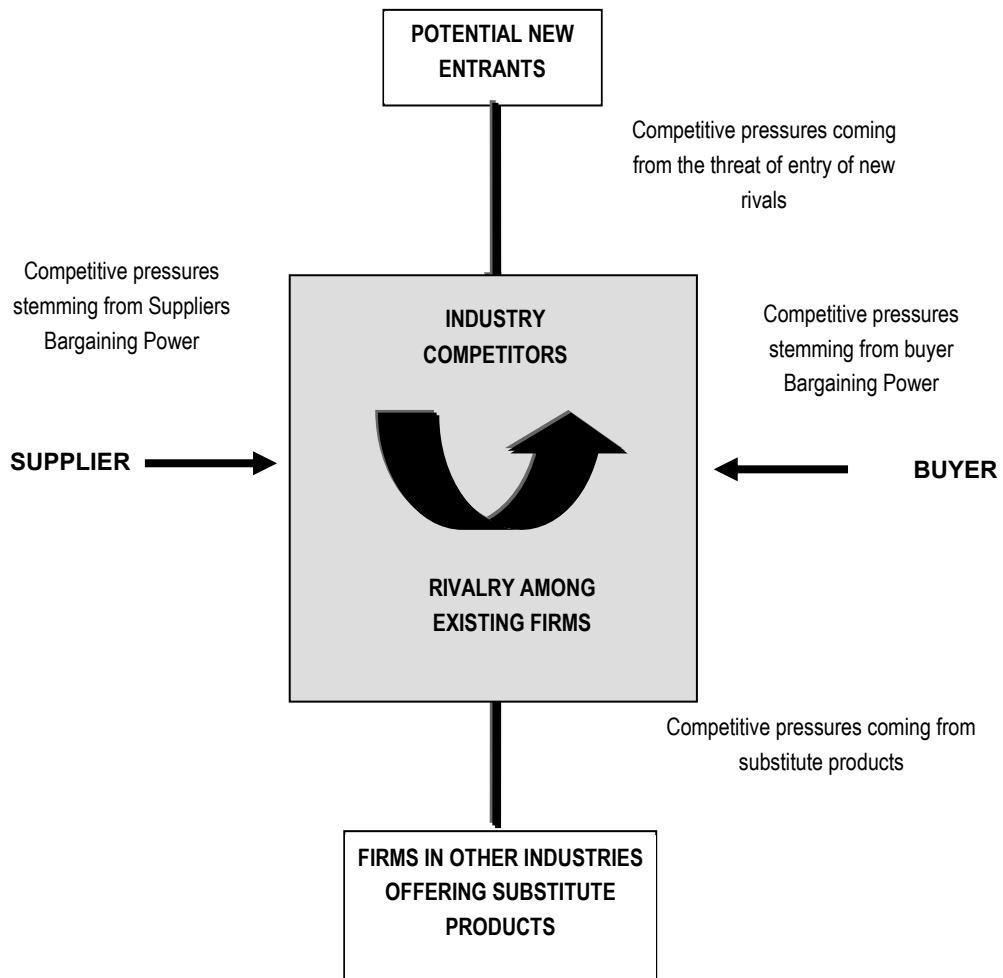
- (c) Environmental scanning is the process of gathering information regarding company's environment, analysing it and forecasting the impact of all predictable environmental changes. Successful marketing depends largely on how a company can synchronise its marketing programmes with its environmental changes.
- (d) Market development refers to a growth strategy where the business seeks to sell its existing products into new markets. It is a strategy for company growth by identifying and developing new markets for current company products. This strategy may be achieved through new geographical markets, new product dimensions or packaging, new distribution channels or different pricing policies to attract different customers or create new market segments.
- (e) An industry's Key Success Factors (KSFs) are those things that most affect industry members' ability to prosper in the marketplace - the particular strategy elements, product attributes, resources, competencies, competitive capabilities, and business outcomes that spell the difference between profit and loss and, ultimately, between competitive success or failure.
- (f) **Strategic surveillance:** Contrary to the premise control, the strategic surveillance is unfocussed. It involves general monitoring of various sources of information to

uncover unanticipated information having a bearing on the organizational strategy. It involves casual environmental browsing. Reading financial and other newspapers, business magazines, meetings, conferences, discussions at clubs or parties and so on can help in strategic surveillance.

Strategic surveillance may be loose form of strategic control, but is capable of uncovering information relevant to the strategy.

4. Five forces model of Michael Porter is a powerful and widely used tool for systematically diagnosing the significant competitive pressures in the market and assessing their strength and importance. The model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the over all market. These five forces are:
 1. **Threat of new entrants:** New entrants are a powerful source of competition. The new capacity and product range they bring in throw up new competitive pressures. The bigger the new entrant, the more severe the competitive effect. New entrants also place a limit on prices and affect the profitability of existing players.
 2. **Bargaining power of customers:** This is another force that influences the competitive condition of the industry. This force will become heavier depending on the possibilities of the buyers forming groups or cartels. The bargaining power of the buyers influences not only the prices that the producer can charge but also influences in many cases, costs and investments of the producer because powerful buyers usually bargain for better services which involve costs and investment on the part of the producer.
 3. **Bargaining power of suppliers:** Quite often suppliers, too, exercise considerable bargaining power. The more specialised the offering from the supplier, greater is his clout. And, if the suppliers are also limited in number they stand a still better chance to exhibit their bargaining power. The bargaining power of suppliers determines the cost of raw materials and other inputs of the industry and, therefore, industry attractiveness and profitability.
 4. **Rivalry among current players:** The rivalry among existing players is quite obvious. This is what is normally understood as competition. For any player, the competitors influence strategic decisions at different strategic levels. The impact is evident more at functional level in the prices being changed, advertising, and pressures on costs, product and so on.
 8. **Threats from substitutes:** Substitute products are a latent source of competition in an industry. In many cases they become a major constituent of competition. Substitute products offering a price advantage and/or performance improvement to the consumer can drastically alter the competitive character of an industry. And they can bring it about all of a sudden. For example, coir suffered at the hands of synthetic

fibre. Wherever substantial investment in R&D is taking place, threats from substitute products can be expected.



5. The business organization and its many environments have innumerable interrelationship that at times, it becomes difficult to determine exactly where the organization ends and where its environment begins. It is also difficult to determine exactly what business should do in response to a particular situation in the environment. Strategically, the businesses should make efforts to exploit the opportunity and thought the threats.

In this context following approaches may be noted:

- (i) **Least resistance:** Some businesses just manage to survive by way of coping with their changing external environments. They are simple goal-maintaining units. They are very passive in their behaviour and are solely guided by the signals of the external

environment. They are not ambitious but are content with taking simple paths of least resistance in their goal-seeking and resource transforming behaviour.

- (ii) **Proceed with caution:** At the next level, are the businesses that take an intelligent interest to adapt with the changing external environment. They seek to monitor the changes in that environment, analyse their impact on their own goals and activities and translate their assessment in terms of specific strategies for survival, stability and strength. They regard that the pervasive complexity and turbulence of the external environmental elements as 'given' within the framework of which they have to function as adaptive-organic sub-systems. This is an admittedly sophisticated strategy than to wait for changes to occur and then take corrective-adaptive action.
 - (iii) **Dynamic response:** At a still higher sophisticated level, are those businesses that regard the external environmental forces as partially manageable and controllable by their actions. Their feedback systems are highly dynamic and powerful. They not merely recognise and ward off threats; they convert threats into opportunities. They are highly conscious and confident of their own strengths and the weaknesses of their external environmental 'adversaries'. They generate a contingent set of alternative courses of action to be picked up in tune with the changing environment.
6. The term strategic management refers to the managerial process of forming a strategic vision, setting objectives, crafting a strategy, implementing and executing the strategy, and then initiating whatever corrective adjustments in the vision, objectives, strategy, and execution are deemed appropriate.

The basic framework of strategic process can be described in a sequence of five stages as follows:

Stage one - Where are we now? (Beginning): This is the starting point of strategic planning and consists of doing a situational analysis of the firm in the environmental context.

Stage two - Where we want to be? (Ends): This is a process of goal setting for the organization after it has finalised its vision and mission.

Stage three - How might we get there? (Means): Here the organization deals with the various strategic alternatives it has.

Stage four - Which way is best? (Evaluation): Out of all the alternatives generated in the earlier stage the organization selects the best suitable alternative in line with its SWOT analysis.

Stage five - How can we ensure arrival? (Control): This is a implementation and control stage of a suitable strategy. Here again the organization continuously does situational analysis and repeats the stages again.

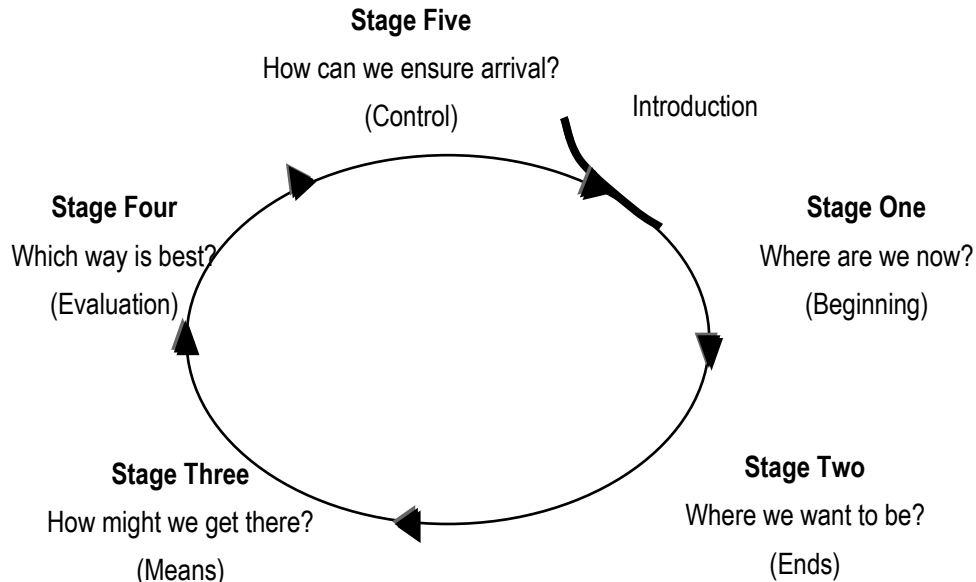


Figure - Framework of strategic management

7. Mission statements broadly describe an organizations present capabilities, customer focus, activities, and business makeup. Following points are useful while writing mission of a company:
 - Good mission statements are highly personalized – unique to the organization for which they are developed.
 - One of the roles of a mission statement is to give the organization its own special identity, business emphasis and path for development.
 - A company's business is defined by what needs it is trying to satisfy, customer groups it is targeting, technologies and competencies it uses and the activities it performs.
 - Technology, competencies and activities are important in defining a company's business because they indicate the boundaries on its operation.
 - The mission should not be to make profit.
8. The model has been used by General Electric Company (developed by GE with the assistance of the consulting firm McKinsey & Company) known as "Stop-Light" Strategy Model. This model is also known as Business Planning Matrix, GE Nine-Cell Matrix and GE Model. The strategic planning approach in this model has been inspired from traffic control lights. The lights that are used at crossings to manage traffic are: green for go, amber or yellow for caution, and red for stop. This model uses two factors while taking strategic decisions: Business Strength and Market Attractiveness. The vertical axis

indicates market attractiveness and the horizontal axis shows the business strength in the industry. The market attractiveness is measured by a number of factors like:

- Size of the market.
- Market growth rate.
- Industry profitability.
- Competitive intensity.
- Availability of Technology.
- Pricing trends.
- Overall risk of returns in the industry.
- Opportunity for differentiation of products and services.
- Demand variability.
- Segmentation.
- Distribution structure (e.g. retail, direct, wholesale) etc.

Business strength is measured by considering the typical drivers like:

- Market share.
- Market share growth rate.
- Profit margin.
- Distribution efficiency.
- Brand image.
- Ability to compete on price and quality.
- Customer loyalty.
- Production capacity.
- Technological capability.
- Relative cost position.
- Management caliber, etc.

		<i>Business Strength</i>		
		<i>Strong</i>	<i>Average</i>	<i>Weak</i>
<i>Market Attractiveness</i>	<i>High</i>			
	<i>Medium</i>			
	<i>Low</i>			

Figure : The GE Portfolio Matrix

<u>Zone</u>		<u>Strategic Signals</u>
<i>Green</i>		<i>Invest/Expand</i>
<i>Yellow</i>		<i>Select/Earn</i>
<i>Red</i>		<i>Harvest/Divest</i>

If a product falls in the green section, the business is at advantageous position. To reap the benefits, the strategic decision can be to expand, to invest and grow. If a product is in the amber or yellow zone, it needs caution and managerial discretion is called for making the strategic choices. If a product is in the red zone, it will eventually lead to losses that would make things difficult for organisations. In such cases, the appropriate strategy should be retrenchment, divestment or liquidation.

9. Industry and competitive analysis can be done using a set of concepts and techniques to get a clear fix on key industry traits, the intensity of competition, the drivers of industry change, the market positions and strategies of rival companies, the keys to competitive success, and the industry's profit outlook. It provides a way of thinking strategically about any industry's overall situation and drawing conclusions about whether the industry represents an attractive investment for company funds. The analysis entails examining a company's business in the context of a much wider environment. Industry and competitive analysis aims at developing insight in several issues. Analysing these issues build understanding of a firm's surrounding environment and, collectively, form the basis for matching its strategy to changing industry conditions and competitive realities. The issues are given below:

- Dominant economic features of the industry.

- Nature and strength of competition.
- Triggers of change.
- Identifying the companies that are in the strongest/weakest positions.
- Likely strategic moves of rivals.
- Key factors for competitive success.
- Prospects and financial attractiveness of industry.

10. Diversification Strategy: Diversification endeavours can be related or unrelated to existing businesses of the firm. Based on the nature and extent of their relationship to existing businesses, diversification endeavours have been classified into four broad categories:

- (i) Vertically integrated diversification
- (ii) Horizontally integrated diversification
- (iii) Concentric diversification
- (iv) Conglomerate diversification

In vertically integrated diversification, firms opt to engage in businesses that are related to the existing business of the firm. The firm remains vertically within the same process. Sequence It moves forward or backward in the chain and enters specific product/process steps with the intention of making them into new businesses for the firm. The characteristic feature of vertically integrated diversification is that here, the firm does not jump outside the vertically linked product-process chain.

Horizontal Integrated Diversification: Through the acquisition of one or more similar business operating at the same stage of the production-marketing chain that is going into complementary products, by-products or taking over competitors' products.

Concentric Diversification: Concentric diversification too amounts to related diversification. In concentric diversification, the new business is linked to the existing businesses through process, technology or marketing. The new product is a spin-off from the existing facilities and products/processes. This means that in concentric diversification too, there are benefits of synergy with the current operations. However, concentric diversification differs from vertically integrated diversification in the nature of the linkage the new product has with the existing ones. The new product is only connected in a loop-like manner at one or more points in the firm's existing process/technology/product chain.

Conglomerate Diversification: In conglomerate diversification, no such linkages exist; the new businesses/ products are disjointed from the existing businesses/products in every way; it is a totally unrelated diversification. In process/technology/function, there is no connection between the new products and the existing ones. Conglomerate diversification has no common thread at all with the firm's present position.

11. Action plan for turnaround strategy, an organization can implement:

- **Stage One – Assessment of current problems:** The first step is to assess the current problems and get to the root causes and the extent of damage the problem has caused. Once the problems are identified, the resources should be focused toward those areas essential to efficiently work on correcting and repairing any immediate issues.
- **Stage Two – Analyze the situation and develop a strategic plan:** Before you make any major changes; determine the chances of the business's survival. Identify appropriate strategies and develop a preliminary action plan. For this one should look for the viable core businesses, adequate bridge financing and available organizational resources. Analyze the strengths and weaknesses in the areas of competitive position. Once major problems and opportunities are identified, develop a strategic plan with specific goals and detailed functional actions.
- **Stage Three – Implementing an emergency action plan:** If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive. The plan typically includes human resource, financial, marketing and operations actions to restructure debts, improve working capital, reduce costs, improve budgeting practices, prune product lines and accelerate high potential products. A positive operating cash flow must be established as quickly as possible and enough funds to implement the turnaround strategies must be raised.
- **Stage Four – Restructuring the business:** The financial state of the organization's core business is particularly important. Prepare cash forecasts, analyze assets and debts, review profits and analyze other key financial functions to position the organization for rapid improvement.

During the turnaround, the "product mix" may be changed, requiring the organization to do some repositioning. Core products neglected over time may require immediate attention to remain competitive. Organisations may also withdraw from some markets, close some facilities or discontinue some products.

The 'people mix' is another important ingredient in the organization's competitive effectiveness. Reward and compensation systems that encourage dedication and creativity encourage employees to think profits and return on investments.

- **Stage Five – Returning to normal:** In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added. Emphasis is placed on a number of strategic

efforts such as carefully adding new products and improving customer service, creating alliances with other organizations, increasing the market share, etc.

12. Once higher level corporate and business strategies are developed, management need to formulate and implement strategies for functional areas such as marketing, financial, production and Human Resource. For effective implementation, strategists have to provide direction to functional managers regarding the plans and policies to be adopted. In fact, the effectiveness of strategic management depends critically on the manner in which strategies are implemented. Strategy of one functional area can not be looked at in isolation, because it is the extent to which all the functional tasks are interwoven that determines the effectiveness of the major strategy.

For each functional area, first the major sub areas are identified and then for each of these sub functional areas, contents of functional strategies, important factors, and their importance in the process of strategy implementation are identified.

In terms of the levels of strategy formulation, functional strategies operate below the SBU or business-level strategies. Within functional strategies there might be several sub-functional areas. Functional strategies are made within the higher level strategies and guidelines therein that are set at higher levels of an organisation. Functional managers need guidance from the business strategy in order to make decisions. Operational plans tell the functional managers what has to be done while policies state how the plans are to be implemented.

Major strategies need to be translated to lower levels to give holistic strategic direction to an organisation. Functional strategies provide details to business strategy & govern as to how key activities of the business will be managed. Functional strategies play two important roles. Firstly, they provide support to the overall business strategy. Secondly, they spell out as to how functional managers will work so as to ensure better performance in their respective functional areas. The reasons why functional strategies are really important and needed for business can be given as follows:

The development of functional strategies is aimed at making the strategies-formulated at the top management level-practically feasible at the functional level.

- Functional strategies facilitate flow of strategic decisions to the different parts of an organisation.
- They act as basis for controlling activities in the different functional areas of business.
- The time spent by functional managers in decision-making is reduced as plans lay down clearly what is to be done and policies provide the discretionary framework within which decisions need to be taken.
- Functional strategies help in bringing harmony and coordination as they remain part of major strategies.
- Similar situations occurring in different functional areas are handled in a consistent

manner by the functional managers.

13. For a new product pricing strategies for entering a market needs to be designed. In pricing a really new product at least three objectives must be kept in mind.
- Making the product acceptable to the customers.
 - Producing a reasonable margin over cost.
 - Achieving a market that helps in developing market share.

For a new product an organization may either choose to skim or penetrate the market. In skimming prices are set at a very high level. The product is directed to those buyers who are relatively price insensitive but sensitive to the novelty of the new product. For example call rates of mobile telephony were set very high initially. Even the incoming calls were charged. Since the initial off take of the product is low, high price, in a way, helps in rationing of supply in favour of those who can afford it.

In penetration pricing firm keeps a temptingly low price for a new product which itself is selling point. A very large number of the potential customers may be able to afford and willing to try the product.

14. Strategy implementation concerns the managerial exercise of putting a freshly chosen strategy into place. Strategy execution deals with the managerial exercise of supervising the ongoing pursuit of strategy, making it work, improving the competence with which it is executed and showing measurable progress in achieving the targeted results. Strategic implementation is concerned with translating a decision into action, with presupposes that the decision itself was made with some thought being given to feasibility and acceptability.

It is crucial to realize the difference between strategy formulation and strategy implementation because they both require very different skills. Also, a company will be successful only when the strategy formulation is sound and implementation is excellent. There is no such thing as successful strategic design. This sounds obvious, but in practice the distinction is not always made. The matrix in the figure below represents various combinations of strategy formulation and implementation:

Strategy formulation	Sound	<i>A</i>	<i>B</i> (Success)
	Flawed	<i>C</i>	<i>D</i>
		Weak	Excellent
		Strategy implementation	

15. The phenomenon which often distinguishes good organizations from bad ones could be summed up as 'corporate culture'. Corporate culture refers to a company's values, beliefs, business principles, traditions, ways of operating and internal work environment. Every corporation has a culture that exerts powerful influences on the behaviour of managers. Culture affects not only the way managers behave within an organization but also the decisions they make about the organization's relationships with its environment and its strategy.

"Culture is a strength that can also be a weakness". This statement can be explained by splitting it in to two parts.

Culture as a strength: As a strength, culture can facilitate communication, decision-making & control and create cooperation & commitment. An organization's culture could be strong and cohesive when it conducts its business according to a clear and explicit set of principles and values, which the management devotes considerable time to communicating to employees and which values are shared widely across the organization.

Culture as a weakness: As a weakness, culture may obstruct the smooth implementation of strategy by creating resistance to change. An organization's culture could be characterized as weak when many subcultures exist, few values and behavioural norms are shared and traditions are rare. In such organizations, employees do not have a sense of commitment, loyalty and sense of identity.

16. TQM is quite different from traditional management practices, requiring changes in organizational processes, beliefs and attitudes, and behaviours. "Traditional management" means the way things are usually done in most organizations in the absence of a TQM focus. Many "traditional" organizations have been applying TQM principles all along, so not all of these comments pertain to every organization. The nature of TQM differs from common management practices in many respects. Some of the key differences are as follows:

- **Strategic Planning and Management:** Quality planning and strategic business planning are indistinguishable in TQM. Quality goals are the cornerstone of the business plan. Measures such as customer satisfaction, defect rates, and process cycle times receive as much attention in the strategic plan as financial and marketing objectives.
- **Changing Relationships with Customers and Suppliers:** In TQM, quality is defined as products and services beyond present needs and expectations of customers. Innovation is required to meet and exceed customers' needs. Traditional management places customers outside of the enterprise and within the domain of marketing and sales. TQM views everyone inside the enterprise as a customer of an internal or external supplier, and a supplier of an external or internal customer. Marketing concepts and tools can be used to assess internal customer needs and to communicate internal supplier capabilities.

- **Organizational Structure:** TQM views the enterprise as a system of interdependent processes, linked laterally over time through a network of collaborating (internal and external) suppliers and customers. Each process is connected to the enterprise's mission and purpose through a hierarchy of micro- and macro-processes. Every process contains sub-processes and is also contained within a higher process. This structure of processes is repeated throughout the hierarchy.
 - **Organizational Change:** In TQM the environment in which the enterprise interacts is considered to be changing constantly. Management's job, therefore, is to provide the leadership for continual improvement and innovation in processes and systems, products, and services. External change is inevitable, but a favourable future can be shaped.
 - **Teamwork:** In TQM individuals cooperate in team structures such as quality circles, steering committees, and self-directed work teams. Departments work together toward system optimization through cross-functional teamwork.
 - **Motivation and Job Design:** TQM managers provide leadership rather than overt intervention in the processes of their subordinates, who are viewed as process managers rather than functional specialists. People are motivated to make meaningful contributions to what they believe is an important and noble cause, of value to the enterprise and society. The system enables people to feel like winners.
17. A significant difference between six sigma and seemingly similar programs of past years is the degree to which management plays a key role in regularly monitoring program results and accomplishments. Six sigma is a system that combines both strong leadership and grassroots energy and involvement. In addition, the benefits of six sigma are not just financial. People at all levels of a six sigma company find that better understanding of customers, clearer processes, meaningful measures, and powerful improvement tools make their work more rewarding.

The critical elements of six sigma can be put into six themes as follows:

- **Theme one** – *genuine focus on the customer:* Companies launching six sigma often find that how little they really understand their customers. In six sigma, customer focus becomes the top priority. For example, the measures of six sigma performance begin with the customer. Six sigma improvements are defined by their impact on customer satisfaction and value.
- **Theme two** – *data and fact-driven management:* Six sigma takes the concept of "management by fact" to a new, more powerful level. Despite the attention paid in recent years to improved information systems, knowledge management, and so on, many business decisions are still being based on opinions, assumptions and gut feeling. Six sigma discipline begins by clarifying what measures are key to gauging business performance and then gathers data and analyzes key variables. Problems are effectively defined, analyzed, and resolved. Six sigma also helps managers to answer two essential questions to support data-driven decisions and solutions.

- a. What data/information is really required?
 - b. How to use the data/information for maximum benefit?
- **Theme three** – *processes are where the action is*: Six sigma positions the process as the key vehicle of success. Processes like designing products and services, measuring performance, improving efficiency and customer satisfaction, may relate to build competitive advantage in delivering value to customers.
 - **Theme four** – *proactive management*: In simple terms, being proactive means acting in advance of events rather than reacting to them. In the real world, though, proactive management means making habits out of what are, too often, neglected business practices: defining ambitious goals and reviewing them frequently, setting clear priorities, focusing on problem prevention rather than fire-fighting, and questioning why we do things instead of blindly defending them.

Far from being boring or overly analytical, being truly proactive is a starting point for creativity and effective change. Six sigma, encompasses tools and practices that replace reactive habits with a dynamic, responsive, proactive style of management.
 - **Theme five** – *boundaryless collaboration*: "Boundarylessness" is one of Jack Welch's mantras for business success. Years before launching six sigma, GE's chairman was working to break barriers and to improve teamwork up, down, and across organizational lines. The opportunities available through improved collaboration within companies and with vendors and customers are huge. Billions of dollars are lost every day because of disconnects and outright competition between groups that should be working for a common cause: providing value to customers.
 - **Theme six** – *drive for perfection; tolerate failure*: Organizations need to make efforts to achieve perfection and yet at the same time tolerate failure. In essence, though, the two ideas are complementary. No company will get even close to six sigma without launching new ideas and approaches - which always involve some risk. Six sigma cannot be implemented by individuals who are overly cautious and are scared of making mistakes.