

*Compliance management, audit and due diligence*

*Marathon notes*

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# UNIT 13 : Secretarial Audit

## *SECRETARIAL AUDIT NEED FOR*

### *SECRETARIAL AUDIT*

- Compliance Verification
- Corporate Governance
- Risk Mitigation
- Stakeholder Confidence
- Preventing Fraud and Mismanagement

- Legal Requirements

Section 204(1) of the Companies Act, 2013 read with rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 provides that-

1. Every listed company;
  2. Every public company having a paid-up share capital of fifty crore rupees or more; or
  3. Every public company having a turnover of two hundred fifty crore rupees or more
- shall annex with its Board's Report made in terms of sub-section (3) of section 134, a Secretarial Audit Report, given by a Company Secretary in practice, in form MR- 3.

**\* Applicability of Section 204 to a Company which is a subsidiary of a Public Company\***

**Objectives of a Secretarial Audit:**

1. Verification of Compliance
2. Assessment of Governance Practices
3. Identification of Legal and Regulatory Risks
4. Evaluation of Board Procedures
5. Review of Statutory Registers and Records
6. Examination of Disclosures and Reporting
7. Assessment of Related Party Transactions
8. Assessment of Related Party Transactions
9. Detection of Fraud and Mismanagement
10. Recommendation of Remedial Measures
11. Enhancement of Stakeholder Confidence

**SECRETARIAL AUDIT AND SECRETARIAL COMPLIANCE REPORT UNDER THE SEBI (LISTING OBLIGATIONS AND DISCLOSURE REQUIREMENTS) REGULATIONS, 2015**

**Regulation 24A:** Every listed entity and its material unlisted subsidiaries incorporated in India shall undertake secretarial audit and shall annex a secretarial audit report given by a company secretary in practice, in such form as specified, with the annual report of the listed entity. Every listed entity shall submit a secretarial compliance report in such form as specified, to stock exchanges, within 60 days from end of each financial year.

Exemptions from Sec audit (Reg 15)

(a) Listed entity having paid up equity share capital not exceeding rupees ten crore and net worth not exceeding rupees twenty five crore

(b) listed entity which has listed its specified securities on the SME Exchange

## ***Appointment of Secretarial Auditor***

As per rule 8 of the Companies (Meetings of Board and its Powers) Rules, 2014, secretarial auditor is required to be appointed by means of resolution at a duly convened meeting of the Board of Directors of the company. The appointment of the Secretarial Auditor should be at the beginning of the financial year as secretarial audit entails checking of compliances on a continuous basis. As a good practice, the Secretarial Auditor should submit a report to the Board at the end of each quarter as to the compliances of the company.

## ***Benefits of a Secretarial Audit***

The risks of non-compliance with these many laws and regulations include:

- Failure to keep proper books and records or non-compliance with the provisions of corporate laws and securities laws, executing certain unviable or undesirable corporate actions or transactions with related parties or loan to directors, issue, allotment and transfer of Security or otherwise, without proper authority of the Board of Directors or the General Meeting or the Memorandum of Association, etc., could lead to the ability by third parties to play with the stakeholder's limited liability protection.
- Failure to obtain proper approvals/permissions/licenses could lead to fines, penalties or/and imprisonment in some cases, even closure of the business by government or governmental agencies.
- Failure to comply with certain laws and regulations may lead to initiation of action by the regulators like MCA, SEBI, RBI or others which may jeopardize the very stability of the financial and manufacturing operations.

- Failure to adopt proper environment law compliance and policies which are reviewed periodically could give rise to governmental and civil liability.
- Failure to keep accurate records and minutes of its decision-making procedures, such as proving that directors are exercising informed judgment, could subject the company and its board to liability to its shareholders and investors.
- Failure to monitor the company's reporting requirements may put the company into default with lenders or investors.
- Company Secretary in Practice acts as an extended arm of the regulators in ensuring the compliances, Detecting and reporting any non-compliance before it takes seriously alarming shape.

### **Other benefits to the Stakeholders are**

- (a) Promoters - Secretarial Audit assures the promoters of a company that those in-charge of its management are conducting its affairs in accordance with the requirements of laws and the owner's stake is not being exposed to unintended risks.
- (b) Non-executive/Independent directors- Secretarial Audit provides comfort to the Non- executive/Independent Directors that appropriate mechanisms and processes are in place to ensure compliance with laws applicable to the company, thus mitigating any risk from a regulatory or governance perspective.

Government authorities/regulators - It also facilitates reducing the burden of the regulators in ensuring compliances and they can take timely actions against the offenders.

- (a) Investors- Secretarial Audit helps the investors in taking informed investment decision, as it evaluates the company in terms of compliance and governance norms being followed by the company.
- (e) Other Stakeholders- It is an effective due diligence exercise for the prospective investors or joint venture partners. Further Financial Institutions, Banks, Creditors and Consumers can measure the law abiding nature of company management.

### ***SCOPE OF SECRETARIAL AUDIT***

***All the laws applicable on the company will cover the scope.***

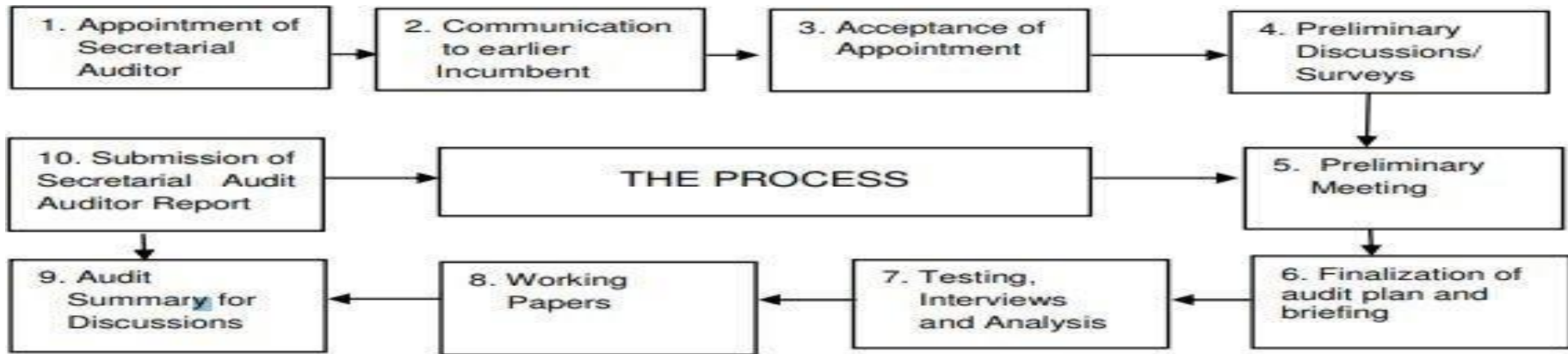
In terms of Form MR-3, the Secretarial auditor needs to examine and report the compliance of the following:

- (i) The Companies Act, 2013 (the Act) and the rules made thereunder;
- (ii) The Securities Contracts (Regulation) Act, 1956 ('SCRA') and the rules made thereunder;
- (iii) The Depositories Act, 1996 and the Regulations and Bye-laws framed thereunder;
- (iv) Foreign Exchange Management Act, 1999 and the rules and regulations made thereunder to the extent of Foreign Direct Investment, Overseas Direct Investment and External Commercial Borrowings;

Further the Secretarial Auditor needs to examine and report on the compliance with the applicable clauses of the following:

- i. Secretarial Standards issued by The Institute of Company Secretaries of India.
- ii. The Listing Agreements entered into by the Company with ..... Stock Exchange(s), if Applicable/ The Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015; Further also the Secretarial Audit report also requires reporting on whether –

- The Board of Directors of the Company is duly constituted with proper balance of Executive Directors, Non-Executive Directors, Independent Directors, and Women Director.
- The changes in the composition of the Board of Directors that took place during period under review were carried out in compliance with the provisions of the Act.
- Adequate notice is given to all directors to schedule the Board Meetings, agenda and detailed notes on agenda were sent at least seven days in advance, and a system exists for seeking and obtaining further information and clarifications on the agenda items before the meeting and for meaningful participation at the meeting.
- Majority decision is carried through while the dissenting members' views are captured and recorded as part of the minutes.



## Verification relating to Constitution of Board and its Processes

### A. Constitution of the Board: Size and Composition

Auditor shall verify the following:

- Minimum number of directors
- Maximum number of directors
- Optimum combination of executive and non-executive directors:
- **Under Companies act, 2013:**
  - The following classes of companies are required to appoint at least 01 Woman Director: (i) Every Listed Company; (ii) Every Other Public Company having – (a) paid-up share capital of 100 crore Rupees or more; or (b) turnover of 300 crore Rupees or more. (149(1))
  - Resident director (182 days) (149(2))
  - Listed public co. should have  $\frac{1}{3}$  of total directors as ID (149(2))

### Under Sebi(LODR), 2015

1. optimum combination of executive and non-executive directors with at least 01-woman director and not less than 50% of the Board of Directors shall comprise of non-executive directors.
2. Where the Chairperson of the BOD is a non-executive director, at least  $\frac{1}{3}$  of the BOD shall comprise ID and where the listed entity does not have a regular non-executive Chairperson, at least  $\frac{1}{2}$  of the BOD shall comprise ID. Provided that where the non-executive chairperson is a promoter or person occupying management positions at the level of the BOD or at one level below the BOD, at least  $\frac{1}{2}$  of the BOD of the listed entity shall consist of ID.
3. The Board of Directors of the top 1000 listed entities shall comprise min 6 directors

## **B. Board Processes**

Under the verification of the board process the following check points shall be observed by the Secretarial Auditors:

Meetings of Board and Committees

Meetings of Committees that exercise powers of the Board under Section 179 of Companies Act, 2013

Meeting of Members Board's performance evaluation and training

Appointment and Resignation of the members of the Board

### **Auditor shall check the board efficiency by:**

- Reviewing records maintained by the Auditee.
- Understanding compliance responsibility centers, control points, matrix, the flow of information, escalation of non-compliances to different levels, reporting of any non-compliance.
- Assessing compliance mechanism and understanding its extent, coverage and severity mapping. The Auditor shall also assess compliance manual/ standard operating procedures, if any, available with the Auditee. Analysing instances of show cause notices received, prosecution initiated, fine or penalties levied, imprisonment ordered, qualification, adverse remark or observations in the statutory, internal or industry specific audit, orders passed by regulatory bodies or judicial/ quasi-judicial authorities

### **C. Board Committee: Composition and Processes**

**Sec auditor shall verify the composition of the following committees:**

Audit Committee

Nomination and Remuneration Committee

Stakeholders Relationship Committee

CSR Committee Risk Management Committee (Note: Secretarial Standard - 1 is not applicable as it is not a Board's Committee under the Companies Act, 2013)

Internal Committee constituted under the POSH Act

### **D. Identification of Events/Corporate Events:**

- Events/ actions altering the Charter documents of the company;
- Changes in the Capital structure of the company;
- Change in the Affairs/ Management of the company;
- Change in the Licensing or permission for the business operation of the company;
- Casual Vacancy of statutory auditor/ director/ KMP; h Borrowing in excess of limits specified in Section 180 of the Companies Act, 2013.

# Secretarial Audit – Fraud Detection and Reporting

## INTRODUCTION

*Frauds under explanation to section 447 defined as under:*

- (i) “Fraud” in relation to affairs of a company or anybody corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;
- (ii) “Wrongful gain” means the gain by unlawful means of property to which the person gaining is not legally entitled;
- (iii) “Wrongful loss” means the loss by unlawful means of property to which the person losing is legally entitled.

## Disclosures in the Board’s Report

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

## Consequence on failure in Reporting of fraud

In case, company secretary in practice does not comply with the provisions of section 143(12), he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty- five lakh rupees. Further, section 143(13) provides that no duty to which an auditor of a company is subject to shall be regarded as having been contravened by reason of his reporting the matter(fraud) if it is done in good faith.

## **PROCEDURE FOR REPORTING OF FRAUD**

### **(i) Reporting of frauds by auditor involving amount more than Rs. 1 crore**

#### **STEP-I - Report to Board & Audit Committee**

Auditor shall forward his report to the Board of Directors or the Audit Committee, as the case maybe, within 2 days of his knowledge of the fraud, seeking their reply or observations within 45 (forty-five) days;

#### **STEP-II - Report to Central Government after reply of board**

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 fifteen days of receipt of such reply or observations;

#### **STEP-IIA - Report to Central Government if no reply received**

In case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45(forty-five 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 failed to receive any reply or observations within the stipulated time.

Other Points to be kept in mind: The report shall be on the letter-head of the auditor containing

- Postal Address;
- e-mail address;
- contact number (telephone/ mobile);
- signed by the auditor with his seal;

- indicate his Membership Number;
- Report shall be in the form of a statement as specified in Form ADT-4.

**(ii) Reporting of frauds by auditor involving amount less than Rs.1 crore**

As per the Sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 in case of fraud involving an amount less than ` 1 Crore, the auditor shall report the matter of fraud to the Audit Committee or to the Board within 2 days of his knowledge of the fraud.

***Transaction which may involve the fraud***

In the past “Fraud” has been noticed in many cases of scams in the following kinds of transactions:-

- Related Party Transactions
- Excessive Managerial remuneration
- Insider Trading
- Inter Company transactions
- Mergers/demergers/acquisitions
- IPO frauds

***Reporting of Fraud by Secretarial Auditor already reported by other auditors***

The Companies Act, 2013 has provided the duties and responsibilities of the each of the auditors such as for Accounting/ Financial related fraud the statutory auditors shall report, while in case of Non-financial fraud the Secretarial Auditor and in case of the fraud relating to the costing Fraud it needs to be reported by the Cost accountant in practice.

## FRAUD V/S NON COMPLIANCE

The term fraud can be defined as act or course of deception, an intentional concealment, omission, or perversion of truth, to

- (1) Gain unlawful or unfair advantage,
- (2) Induce another to part with some valuable item or surrender a legal right, or
- (3) Inflict injury in some manner.

**Non Compliance:** the term non-compliance refers to failure to comply with the laws, rules regulations etc., the term non-compliance is commonly used in regard to a failure to meet the compliance requirements or failure to doing compliance be it the failure in following procedures, filing of information, eligibility conditions, reporting etc.

The relationship between the Fraud and the non-compliance can be constructed as the non-compliance in the company may lead to a fraud however it may also be noted that the fraud can also be made in the compliant company.

## IDENTIFICATION AND REPORTING OF THE EVENTS/ACTIONS HAVING MAJOR BEARING ON AUDITEE'S AFFAIRS

### Under SEBI(LODR)

1. default in timely payment of interests/preference dividend or redemption or repayment amount or both in respect of the NCDS and NCRPS and also default in creation of security for debentures as soon as the same becomes apparent;
2. any attachment or prohibitory orders restraining the company from transferring non-convertible securities from the account of the registered holders
3. any action which shall result in the redemption, conversion, cancellation, retirement in whole or in part of any non-convertible securities;
4. any action that shall affect adversely payment of interest on NCDS or payment of dividend on NCRPS
5. any change in the form or nature of any of its NCDS or NCRPS that are listed on the stock exchange(s) or in the rights or privileges of the holders thereof and make an application for listing of the securities as changed, if the stock exchange(s) so require;
6. any changes in the general character or nature of business/activities, disruption of operation due to natural calamity, and commencement of commercial production/commercial operations;
7. any events such as strikes and lock outs which have a bearing on the interest payment/dividend payment/ principal repayment capacity;
8. details of any letter or comments made by debenture trustees regarding payment/non-payment of interest on due dates, payment/non-payment of principal on the due dates or any other matter concerning the security, listed entity and/or the assets along with its comments thereon, if any;
9. delay/default in payment of interest or dividend/principal amount/redemption for a period of more than three months from the due date;
10. failure to create charge on the assets within the stipulated time period;

## Lesson 14: Internal Audit and Performance Audit

### ***DEFINITION OF INTERNAL AUDIT: As defined by the Institute of Internal Auditors (IIA)***

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. The internal audit activity evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to:

- Effectiveness and efficiency of operations.
- Reliability and integrity of financial and operational information.
- Safeguarding of assets.
- Compliance with laws, regulations, and contracts.

### ***INTERNAL AUDIT UNDER THE COMPANIES ACT, 2013***

As per Rule 13 of Companies (Accounts) Rule, 2014, the following class of companies shall be required to appoint an internal auditor which may be either an individual or a partnership firm or a body corporate, namely:

- (a) Every listed company;
- (b) Every unlisted public company having-
  - (i) Paid up share capital of fifty crore rupees or more during the preceding financial year;
  - (ii) Turnover of two hundred crore rupees or more during the preceding financial year;

- (i) Outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year;
- (iv ) Outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
- (c) Every private company having-
  - (i) Turnover of two hundred crore rupees or more during the preceding financial year; or
- (ii) Outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or

### ***APPOINTMENT OF INTERNAL AUDITOR***

**Section 179**-Resolutions passed by the Board of Directors at the meetings of the Board. Also the resolution for appointment of the Internal Auditor shall be filed with the Registrar of Companies **within 30 days** from the passing of the said resolution pursuant to the provisions of Section 117 & 179 of the Companies Act, 2013. In case of Private Companies, an exemption has been granted from filing of E Form MGT-14, vide notification issued by the Ministry of Corporate Affairs dated 5th June, 2015.

### ***OBJECTIVE OF INTERNAL AUDIT***

The main objective of the Internal Audit process is to provide an assurance on the organization's risk management, internal control environment and governance framework through review and appraisal of:

- a) Operations control framework including fundamental and basic systems in all areas of the business. The adequacy of risk identification, assessment and mitigation in the organisation. This shall include fraud risks.
- b) Extent, adequacy, relevance of, and compliance with existing policy, plans and procedure documents within the Organisation.
- c) The extent of compliance with relevant statutory requirements
- d) Status of implementation of internal / external audit recommendations
- e) Evaluating internal control.
- f) Determines of the organisation
- g) Establishes the risk management framework
- (h) Identifies potential threats and assesses risks
- (i) Decides on response to risks like implementation of control

## Terms of reference for internal audit team

Strategy and objectives;

Role and responsibilities within the organisation;

Scope of work;

Accountability to the audit committee;

Reporting lines for line management purposes;

Accessibility to the board and the audit committee; and

Unfettered access to all information, people and records across the organisation.

**Question: Is there any penalty for non-compliance with respect to appointment of internal auditor?**

**Answer:** Yes, If a company or any other officer of the company, contravenes the provisions of this section, then the company or any officer of the company who is in default is liable for punishment with a penalty of up to Rs.10,000. In case of continuation of default in complying with the above section further fine of Rs.1,000 per day will be imposed subject to a maximum of Rs. 2,00,000 in case of a company and Rs. 50,000 in case of an officer who is in default or any other person.

## ***INTERNAL AUDIT CORE PRINCIPLES***

- Demonstrates integrity.**
- Demonstrates competence and due professional care.
- Independent and objective exercise.
- Aligns with the strategies, objectives, and risks of the organisation.
- Is appropriately positioned and adequately resourced.
- Demonstrates quality and continuous improvement.
- Communicates effectively.
- Provides risk-based assurance.
- Is insightful, proactive, and future-focused.
- Promotes organizational improvement.

**Nature: 1. A Management tool:** Internal Audit is management tool performed by the employees of the organisation or the engaged professional firm to check the appropriateness of internal checks and control in the organisation. The reporting authority is generally board of directors and audit committee. **2. A continuous Exercise:** Internal Audit is a continuous and systematic process of examining and reporting the operations and records **3. A Control System:** It is a control system concerned with examination and appraisal of other control mechanisms. **4. A Risk Management Tool:** It helps in risk management process and ensuring it addresses key objectives, and the subsequent evaluation of the process. The internal audit work also encompasses an identical role in the creation and subsequent evaluation of, the

## ROLE OF COMPANY SECRETARY AS AN INTERNAL AUDITOR

- Ensure proper following of accounting standards and conventions by the company.
- Ensure audit of the company's financial statements and books of accounts.
- Ensure management of compliance timely and properly and true representation of management funding and financial risk in business.
- Ensure safely keeping of records of meetings held in the company. Provide required advisory on finance usage and corporate litigation.
- Ensure proper management of capital, debt and tax planning. Prepare cost structures and representing efficiency indicators of the business. Design audit methodologies and reporting criteria.

### Other Skills required by Internal auditor:

#### Analytical/Critical thinking skills

#### 2. Data mining and Analysis Skills

#### 3. Good Business Acumen and the ability to understand different business needs.

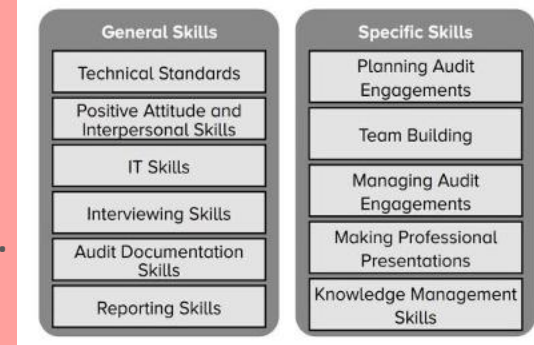
#### 4. He should have the ability to trace out facts and figures

#### 5. Should be methodical and tactful while dealing with people and processes

#### 6. Should be a hard worker, always cautious, vigilant and inquisitive

#### 7. Should be courageous, assertive and determined with the ability to take independent decisions

#### 8. Should lead by being punctual, reliable and updated with the latest knowledge and skill set



## General Skills

1. **Technical Standards:** The internal auditor should have adequate knowledge of the applicable Indian Accounting Standards and also in-depth knowledge on how to apply them in practice.
2. **Positive Attitude and Interpersonal Skills:** The internal auditor should possess positive and objective attitude, free of any prejudice. He should possess good interpersonal and communication skills.
3. **IT Skills:** Internal auditor should either have or acquire sufficient knowledge of how information technology has been integrated in the functioning of the organization and also skills that would enable him to effectively use IT tools in carrying out a purposeful internal audit.
4. **Interviewing Skills:** It involves detailed questioning on various processes and procedures to ascertain whether the client's organization complies with the established standard operating procedure and practices
5. **Audit Documentation Skills:** Audit documentation is the process of compiling and filing of the findings of audit.
6. **Reporting Skills:** It is therefore necessary that the audit report is written in such a manner that all issues are reported objectively and process gaps are addressed properly.

## Specific Skills

1. **Planning Audit Engagements:** This involves the ability to plan audit engagements on the basis of a comprehensive risk assessment prior to commencement of audit. The individual has to be experienced in the conduct of a brainstorming discussion on risk assessment.
2. **Team Building:** This involves collecting people and facilitating coordination among them to ensure that they work as a unified team.
3. **Managing Audit Engagements:** It involves the task of meeting auditees, understanding their expectations, communicating the engagement plan to them, selecting the right team, etc.
4. **Making Professional Presentations:** An experienced internal auditor should be able to make effective presentations to the Audit Committee in a clear and unambiguous manner.

## SCOPE OF INTERNAL AUDIT

**1. Review of Internal Control Systems and Procedures** The internal auditor should determine whether the internal control system is in consonance with the organizational structure. Each control should be reviewed and analysed in terms of its costs and benefits.

**2. Reliability and Integrity of Financial and Operating Information:** the internal auditor should review the means used for measuring, classifying and reporting information including the records from which the information is extracted. He should examine the accuracy and reliability of financial and operational records.

**3. Economical and Efficient Use of Resources:** The internal auditor should check whether proper operating standards and norms have been established for measuring economical and efficient use of resources. They should be detailed enough to be identifiable with specific operating responsibilities and should be capable of being used by operating personnel for monitoring and evaluating their performance.

**4. Compliance with Laws, Policies, Plans, Procedures, and Regulations:** It is essential that the various functional segments of an enterprise comply with the relevant policies, plans, procedures, laws and regulations so that the operations are carried out in coordinated manner

**5. Review of Organizational Structure** The internal auditor should conduct an appraisal of the organisation structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the assignment of responsibilities is in consonance therewith.

**Accomplishment of Established Goals for Operations** The internal auditor should review the overall objectives of the enterprise to evaluate whether they are clearly stated and are attainable. The translation of such overall objectives into specific objectives for each department and programme should be reviewed.

## INTERNAL AUDIT TECHNIQUES

### INTERNAL AUDIT TECHNIQUES

#### **(a) Review Environment of Operating Environment -**

A environment ethical describes management style qualities and business

**(b) Review Controls-** An auditor applies generally accepted auditing standards (GAAS) to detect mechanisms, procedures, tools and methodologies that build controls.

**(c) Test Controls-** An internal auditor tests a business organization's controls, policies and guidelines to ensure that such controls are adequately designed and are operating effectively

**(d) Account Details-** An auditor internal performs tests of details to ensure account that statements of a business entity are not financial "materially misstated."

## ROLE OF INTERNAL AUDIT IN ORGANIZATION CONTROL MECHENISM

### **1. Internal Control Objectives**

- i. To ensure that the transactions are executed in accordance with management's general or specific authorization;
- ii. To make sure that all the 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. To ensure assets are safeguarded from unauthorised access, use or disposition; and
- iv. To make sure that appropriate action is taken with regard to any differences between the recorded assets are compared with the existing assets at reasonable intervals.

## **2. Risk management**

Risk management relating to an organization objectives, and identification, analysis, and response to those risks that could potentially impact its ability to realize its objectives. the risks fall under strategic, operational, financial reporting, and legal/regulatory categories. Management performs risk assessment activities as part of the ordinary course of business in each of these categories. Examples include: strategic planning, marketing planning, capital planning, budgeting, hedging, incentive payout structure, and credit/lending practices.

## **3. Corporate Governance**

The internal auditor is often considered one of the “four pillars” of corporate governance, the other pillars being the Board of Directors, management, and the external auditor. A primary focus area of internal auditing as it relates to corporate governance is helping the Audit Committee of the Board of Directors (or equivalent) perform its responsibilities effectively.

## EVALUATION OF INTERNAL AUDIT FUNCTION BY AN AUDITOR

- 1. Organisational Status** - Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself.
- 2. Scope of Audit Function** - The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management.
- 3. Technical Competence** - The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency.
- 4. Due Professional Care** - The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented.
- 5. Monitoring of internal control:** The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.
- 6. Examination of financial and operating information:** The internal audit function may be assigned to review the means used to identify, measure, classify and report financial and operating information
- 7. Review of operating activities:** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.
- 8. Review of compliance with laws and regulations:** The internal audit function may be assigned to review compliance with laws, regulations and other external requirements
- 9. Risk management:** The internal audit function may assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.

# Lesson 10 -Audit Principles and Techniques

## INTRODUCTION

The auditing principles defines governing an Audit and includes the professional responsibilities, which Should be observed by the auditor while carrying out any audit assignments, Some of these principle are as under:

- Integrity objectivity and independence:** being trustworthy, straightforward, honest, fair and candid; acting and making decisions and judgements impartially, fairly and on merit, freedom from bias.
- Confidentiality:** He can't uncover any delicate data to any outsider except if it is a necessity by law
- Skill and competence:** The examiner should be capable and prepared in the strategies of auditing, for example, he should be qualified as an examiner.
- Work performed by others:** The extent of an audit on occasion can be extremely immense. So an auditor can utilise his representatives, delegates, and others who work under him.
- Documentation:** the examiner keeps a review notepad, a review or audit plan, and an evaluating document or an audit file
- Planning:** A review plan permits the inspector to arrange his work and empowers him to be more proficient and idea
- Audit evidence:** The auditor should gather sufficient proof to help him in his last assessment. This assortment of such proof is finished by substantive and consistency systems.
- Accounting System and Internal Control:** The inspector needs to guarantee that the records of the association are exact and address a valid and reasonable image of the monetary status of the organisation
- Audit conclusions and reporting**

|   |  |
|---|--|
| 1. Inspection of the Documents and records: | <ul style="list-style-type: none"> <li>• To find whether the transactions and the supporting document are appropriate.</li> <li>• To ensure whether the transactions are authorized (approved).</li> <li>• To ensure whether the classification of the transaction is proper.</li> </ul>                                   |
| 2. Observation:                             | The auditor observes a particular procedure being carried by the organization.   |
| 3. Inquiry and Confirmation                 | <p>Inquiry: Seeking information from persons belonging to the organization or from outside organization is called inquiry.</p> <p>Confirmation: Confirming the information available with the records of the organization or with the persons mostly from outside the organization through an inquiry is confirmation.</p> |
| 4. Computation                              | An auditor makes appropriate calculations and verifies the accuracy of the accounting records.   |
| 5. Analytical Procedures                    | The purpose of analysis is to ensure consistency of accounting methods and also to evaluate the efficiency of the management by comparing the results of several years.  |

**6. Compliance** :- To check the arithmetical accuracy of accounting record, the balancing accounts can be compared with the vouchers to test the reliability of data. **7. Compliance Test** :- These tests are designed to check the effectiveness and compliance of internal control. In obtaining the audit evidence, auditor is concerned with the existence of effective internal control. **8. Use of Computer Techniques** :- There are large number of audit techniques like audit software, test packs and mapping which can be used by the auditor to test the accuracy of the data. **9. Substantive Test** :- These are designed to obtain evidence that data produced by accounting system is accurate or not. **10. Dependence on Experts and Auditors** :- The auditor has to rely on the internal and other auditors to complete his work. He has also to rely on other experts like lawyers, engineers and doctors for their expert opinion about the business.

## PRELIMINARY PREPARATION:

1. Understanding the entity
2. Assessing risk
3. Developing an audit plan
4. Assigning audit team members
5. Communicating with the entity
6. Developing audit programs
7. Establishing an audit file

### Audit Planning

The process of audit planning should include the following elements:

1. The purpose and objectives
2. Legal framework under which the audit is being conducted
3. Significant areas and issues involved
4. Process and technique to be adopted
5. Check points, activities
6. Allocation of work contents amongst the staff
7. Time schedules for completion of various tasks/ phases
8. Determining time lines for submission of Draft Report, discussion thereon with the auditee and submission of final report
9. Areas to be classified on "Risk" criteria to allocate suitable resources
10. Determining the extent of detailed examination and coverage in terms of volume
11. Evaluation of internal controls and professional work carried out by other agencies / experts and placing reliance thereon
12. Materiality considerations and determining the threshold therefore

# Questionnaire

Questionnaire is a comprehensive series of questions concerning internal control

Here are certain points to be kept in mind as to how a questionnaire may be used in an audit:

1. **Planning the audit:** The auditor reviews the auditee's documentation and identifies areas of potential risk. The auditor then designs a questionnaire that is tailored to the specific risks and issues identified.
2. **Administering the questionnaire:** The questionnaire is sent to the auditee to complete. The auditee is given a deadline to complete and return the questionnaire.
3. **Analyzing the responses:** The auditor analyzes the responses to the questionnaire to identify areas of concern and potential risk. The responses can also help the auditor to identify areas where additional information or documentation is needed.
4. **Conducting follow-up interviews:** Based on the responses to the questionnaire, the auditor may conduct follow-up interviews with key personnel to gather additional information and clarify any areas of concern.
5. **Reporting the findings:** The auditor prepares a report that summarizes the findings of the audit, including any areas of concern identified through the questionnaire and follow-up interviews.

## Interacting through interviews

**Orientation** is normally part of the audit team's learning process during the planning phase. It aims at exploring and giving an overview of a specific area or function, e.g., by asking for presentations of activities, explanations of formal or informal networks or interpretation of documents (reports, instructions or, budgets).

**Examination** aims at more specific issues with a view to establishing new information, often to be used as audit evidence

**Confirmation**, finally, often goes together with either orientation or examination, but deserves to be mentioned as a separate purpose because of its fundamental importance. Confirmation, by definition, is typically based on information that has already been gathered.

## AUDIT PROGRAMME

Audit programmes are prepared on the basis of audit plan usually by the auditor who is signing the Audit Report of the company. But sometimes, auditors have a basic audit programme and the same is used by the auditor after making some modifications to it to make it according to the audit engagement in hand. Mostly it is in the form of a checklist which can be used by the Audit executives to make sure every required procedure has been implemented. This can also help in monitoring the work of Audit executives in specific or assistants in general.

### Difference between Audit Plan and Audit Programme

| <b>Audit Plan</b>   | <b>Audit Programme</b>  |
|---|---|
| Audit Plan lays down the audit strategies to be followed for conducting an audit such as identifying the areas where special audit consideration and skills may be necessary, obtain the knowledge of business etc.   | Audit programme is an outline of how the audit is to be done, who is to do what work and within what time   |
| Plans should be made to cover the following among other things: <ul style="list-style-type: none"><li>(i) Acquiring knowledge of accounting systems, policies and internal control procedures</li><li>(ii) Establishing the expected degree of reliance to be placed on the internal control</li><li>(iii) Determining the nature, timing and extent of the audit procedures to be performed</li><li>(iv) Co-ordinating the work to be done</li></ul> | It lays down the following audit procedure to be followed : <ul style="list-style-type: none"><li>(i) Evaluation process</li><li>(ii) Ascertaining accuracy</li><li>(iii) Verification of Document</li><li>(iv) Scrutiny of supporting Documents</li><li>(v) Checking of overall disclosure and presentation of all items in the audit completion.</li><li>(vi) Preparation and submission of audit report.</li></ul> |

## **CREATION OF MASTER CHECKLIST**

### **Entity operation and organizations:**

**This checklist contains the matters relating to:**

- Product manufactured/ service delivered/ operation performed by the company.
- Statutory status basis for these operations.
- Objects of the Company as per the memorandum of Association
- Capital structure of the company and funding status.
- Details of the promoters and directors of the company
- Details of Subsidiaries, Joint ventures and Associate companies
- Transactions with the related parties.

- 2. Financial & Non-financial Reporting Requirement:** This checklist generally covers the points relating to changes in laws, regulations, accounting standards, accounting rules or accounting policies since the last audit, new heads of accounts introduced since the last audit, changes in the format of accounts or any such item which require exercising of judgement or estimation. In case of the non-financial disclosures and reporting requirement the audit team should have the detailed requirements under legal and regulatory framework along with the procedural requirements of the same. The auditor should check the limits, eligibility, criteria etc. on the various dates to understand the compliance requirement
- 3. Legal and regulatory requirement:** It is the most important for the auditor to have the detailed compliance requirement applicable to the company and such checklist should cover the section wise compliance requirement highlighting the amendment during the audit period
- 4. Matter of Shareholder & public interest:** It includes the public deposit, loan and advances dividend, corporate social responsibility, small shareholders interest, high level of comment in media etc.
- 5. Review of Control Environment:** The operating environment and culture – Management commitment to designing and maintaining reliable accounting systems – The ability of management to control the operations – The organizational structure of the entity – Methods of assigning authority and responsibility – Supervision and monitoring – Senior management control methods.

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## **WORKING PAPERS AND MAINTENANCE OF WORK SHEET**

### **Working Papers**

Working papers include all the evidence gathered by auditor indicating what work has been done by him and the procedure he has followed in verifying a particular asset or a liability and also provide information that whether:

–Audit was properly planned;

–Audit was carried out;

–Audit was adequately supervised;

–The appropriate review was undertaken;

–The evidence is sufficient and appropriate to support the audit opinion. The working papers may include:

(a) Planning documents and audit programs. (f) Results of control evaluations.

(b) Internal control questionnaires, flowcharts, checklists and narratives. (g) Audit reports and management responses

(c) Notes and minutes resulting from interviews.

(d) Organizational data, such as charts with job descriptions, process chart.

(e) Copies of important documents.

### **Scanned Documents as working papers**

Scanned documents should include a reference to the source and the purpose of the document which is relevant to understand or appreciating the actual audit work performed. Such information needs to be included only when it is not provided elsewhere in the working papers.

### **Tick marks**

Tick marks do not need to be standardized throughout the set of working papers, but must be consistent throughout a particular work paper. Tick mark explanations must be a part of the working paper or included in a separate tick mark legend work paper.

### **Cross Referencing**

Cross-references should be used to refer information useful in more than one place or to other relevant information including the source of information, composition of summary totals, or other documents or examples of transactions..

### **Standard Working papers**

A standard set of working papers will include at least the following documents:

- A. General File: The General File contains key information through the various phases of the audit including planning (audit objectives, planning comments including etc.), reporting process, audit programs and comments for the next audit. The General File will include the draft and final reports. Audit responses will also be included in the file.
- B. Work paper File: This file should contain the detailed audit procedures and detailed audit working papers. Detailed audit procedures provide detailed audit steps of the audit work to be performed during fieldwork that will achieve the specific audit objectives outlined in the audit program.
- C. Future Audit Considerations: Auditors are encouraged to develop and document future audit ideas during the course of their work. These should be included in the "Comments for next audit" section of the General File

**(i) Permanent File**

The permanent file usually contains documents and matters of continuing importance of clients' business which will be required for more than one audit. The data in these file are the information, which is of continuous interest and relevant to succeeding audits. Data in this file can include the following:

A. Statutory Documents

B. The rules and regulations of the company

- Memorandum of Association
- Articles of Association
- Certificate of Incorporation / Commencement of Business
- Registration documents under various statutory bodies

C. Copies of documents of continuing importance and relevance to the auditor

- Letter of engagement and Board Resolution for appointment of the auditor
- Record of communication with the retiring auditor
- Royalty Agreement / Technical collaboration
- Copies of important legal documents/contracts

D. Addresses of the registered office and business -The Company's registered office address and all other units/premises, with a short description of the work carried on at such places.

K. Company's advisors - A list of the company's advisors such as bankers, merchant bankers, stockbrokers, solicitors, valuers, insurance brokers etc.

information not included in the individual audit files.

## **Working paper Review**

The auditor should review all working papers to determine whether they are relevant and have a useful purpose, evidence the audit work performed and sufficiently support the audit findings. In addition, the auditor should ensure the conclusions reached were reasonable and valid, and that the Office working paper standards were followed. The review will consist of:

- A. Determining compliance with working paper guidelines.
- B. Reviewing the audit program that outlines the major objectives of the audit, and ensure that the procedures accomplish the objective(s).
- C. Reviewing the audit procedures and the referenced working papers to ensure the working papers support the procedures performed and all procedures have been completed.
- D. Determine that the working papers adequately document the conclusions reached in the report.
- E. Ensuring that all findings prepared have been discussed with the appropriate member of management, and that the disposition of the audit concerned is documented.
- F. Documenting review notes.

## **Filing and Protection of Working papers**

All working papers that are considered confidential, are the property of the Auditor, and are to be kept under adequate control. Working papers often contain sensitive information or data that must be protected from unauthorized use or review.

## **Retention Policy**

All working papers pertaining to an audit belong to the Auditor. All such data is to be kept by the Auditor and is subject to the retention requirements as required by law.

## IDENTIFICATION OF THE EVENT AND CORPORATE ACTIONS

- 1) Acquisition(s)
- 2) Issuance or forfeiture of securities
- 3) Revision in Rating(s).
- 4) Outcome of Meetings of the board of director relating to
  - Dividends and/or cash bonuses recommended or declared or the decision to pass any dividend and the date on which dividend shall be paid/dispatched;
  - Any cancellation of dividend with reasons thereof;
  - The decision on buyback of securities;
  - The decision with respect to fund raising proposed to be undertaken
  - Increase in capital by issue of bonus shares through capitalization including the date on which such bonus shares shall be credited/dispatched; etc
- 5) Agreements (viz. shareholder agreement(s), joint venture agreement(s)
- 6) Fraud/defaults by promoter or key managerial personnel or by Company or arrest of key managerial personnel or promoter.
- 7) Change in directors, key managerial personnel (Managing Director, Chief Executive
- 8) Officer, Chief Financial Officer, Company Secretary etc.), Auditor and Compliance Officer.
- 9) Appointment or discontinuation of share transfer agent.
- 10) Corporate debt restructuring.
- 11) One time settlement with a bank.
- 12) Commencement or any postponement in the date of commencement of commercial production or commercial operations of any unit/division
- 13) Change in the MOA etc.

## TESTING METHODS USED DURING AUDIT PROCEDURES

Purpose of Internal Controls Testing 1. Shortening the audit process 2. Providing additional audit evidence to demonstrate compliance

1. **Inquiry:** With the inquiry method, auditors ask questions of the organization's managers, accountants and any other key staff to help determine some relevant information. The auditor may ask about business processes and the appropriate recording of financial transactions to make sure the company is doing everything possible to avoid risks. One example of inquiry commonly used is asking the business owner how the company's financial and data security records are stored
2. **Observation:** Another simple, basic and effective testing method involves an auditor's observation of tasks, procedures and conditions. This testing method is most often used when there is no documentation of the operation of a control. Traditionally, observation has been performed on-site during the evidence-gather phase of a SOC audit. For example, management at an audited organization may state that certain noted records have been appropriately secured in a locked drawer.
3. **Examination or Inspection of Evidence:** This testing method helps auditors determine whether manual controls are being consistently performed and properly documented.
4. **Re-performance:** Re-performance is used when inquiry, observation, and physical examination and inspection have failed to provide the requisite assurance that a control is operating effectively.
5. **Computer-Assisted Audit Technique (CAAT):** The CAAT method of testing is often used to analyze large volumes of data or a sample of compiled data. Using special software, CAAT testing runs a script over a ledger, spreadsheet, or an entire database, to spot trends, irregularities, and potentially fraudulent entries.

## AUDIT SAMPLING

Audit sampling is an investigative tool in which less than 100% of the total items within the population of items are selected to be audited. It is an auditing technique that provides supporting evidence that allows auditors to issue audit opinions without having to audit every single item and transaction.

**Statistical audit sampling** Statistical audit sampling involves a sampling approach where the auditor utilizes statistical methods such as random sampling to select items to be verified. Random sampling is used when there are many items or transactions on record.

**. Non-statistical audit sampling** In contrast to statistical audit sampling, non-statistical audit sampling items are not chosen randomly. Instead, they are chosen based on the auditor's judgment, and the result of the testing from the selections is not used to infer the conclusion for the entire population

## SUBSTANTIVE TESTING

Substantive testing is an auditing technique that checks for any errors or material misstatements in a company's accounts, financial statements or supporting documents without relying on IC.

### STEPS:

#### 1. company makes assertions:

- Occurrence or existence
- Disclosure and presentation
- Obligations and rights
- Accuracy or valuation
- Completeness

#### 2. The auditor creates a plan:

- Examine physical adjustments and journal entries
- Match the underlying accounting records
- Test the different classes of account balances, transactions and disclosure

3. An **auditor shares audit results** with a company The auditor writes an official report listing any errors or material misstatements that the audit found,

## AUDIT TRAIL

### What is the purpose of an audit trail?

The main reason for documenting everything that a company or its employees do is to have a record that can be revisited if the need arises. In case of any discrepancy, you have a pathway that can lead to the erring or fraudulent transaction which is causing the discrepancy. The trail is basically a way to ensure that there are no gaps in data that may lead to a blind spot, making it impossible to determine the cause of the error

### The MCA audit trail system has several benefits, including:

1. **Increased transparency:** The audit trail system provides a detailed record of all transactions, making it easier for regulators and stakeholders to monitor the activities of companies and to detect any irregularities.
2. **Improved accuracy:** By requiring companies to maintain accurate electronic records, the audit trail system helps to prevent errors and omissions in financial reporting.
3. **Greater accountability:** The audit trail system holds companies and their employees accountable for their actions by providing a detailed record of all changes made to electronic records.
4. **Enhanced regulatory compliance:** The audit trail system helps to ensure that companies comply with various laws and regulations related to corporate governance and financial reporting.

# UNIT 11: AUDIT PROCESS AND DOCUMENTATION

## OVERVIEW OF THE AUDIT PROCESS

The audit process can be broadly grouped in three phases:

- a. Planning
- b. Executing
- c. Reporting

### **Audit Planning**

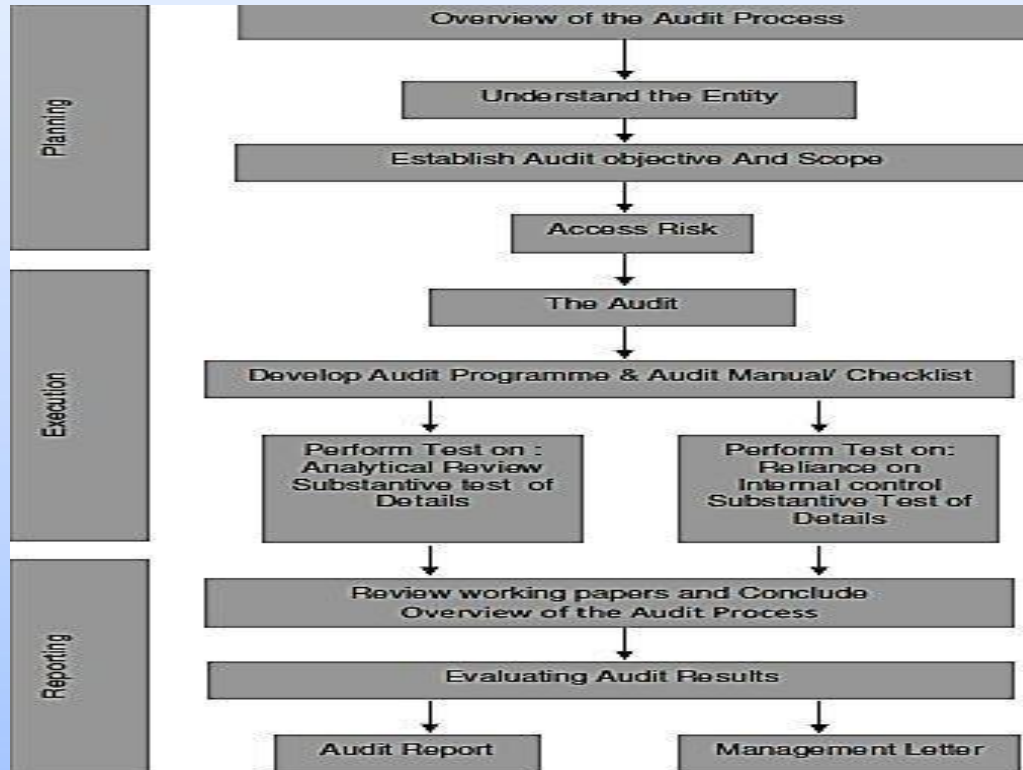
- ✓ Understanding the company
- ✓ Establishing audit objectives and scope
- ✓ Determining Materiality
- ✓ Assessment of Risk
- ✓ Preparation of Audit plan
- ✓ Preparation of detailed audit programme

### **Execution of Audit**

- ✓ Sampling for testing of controls
- ✓ Identification of events
- ✓ Performing controls testing procedures
- ✓ Performing analytical procedures
- ✓ Sampling for substantive test of details
- ✓ Performing substantive test of details
- ✓ Review of working papers
- ✓ Management Discussion on Draft Report

## Reporting

In the reporting phase, the auditor covers evaluation of audit results, deriving conclusion, forming of opinion and prepare the audit report.



## AUDIT PLAN INCLUDES:

Identification of broad audit areas;

Seeking previous audit findings and observations from the Management and the Predecessor or Previous Auditor, in case of change of Auditor;

Determination of subject matters and audit areas requiring special attention, when considered necessary;

Risk Assessment and Materiality;

Audit technique;

Allocation of audit resources for the audit; and

Preparation of audit schedule.

## Essentials of Audit Planning

The Audit planning helps to develop an audit approach which will ensure that sufficient appropriate evidence is gathered to support the audit opinion in the most cost effective manner. For a successful audit plan, the following points should be considered by auditor:

Ensuring the quality of Audit: The Audit should be planned in such manner, which ensures the high quality of audit in economic, efficient, and effective way and in a timely manner.

Documented Audit Plan: The Audit plan should be documented and should be kept with the audit working papers.

Clubbing of inter related steps: The Inter related steps and events should be clubbed together.

Finalization type of Audit Plan: The elements of an audit plan may be similar for different auditee entities. However, the actual contents may differ from auditee to auditee enterprise, and on nature, type & objective of the audit or authentication assignment.

Independent review of Audit Plan : The audit plan should be reviewed by the experienced auditor, normally not engaged on the assignment. Their experience may be useful to modify the audit plan to meet the audit objectives more vigorously.

Flexibility: The audit plan should be flexible enough to accommodate modifications which may be necessary and should be carried out with the approval of team leader.

Reaching conclusion: Auditing involves the collection and analysis of facts and data sufficient to reach reliable and valid conclusions about the subject of the audit.

Training and communication to Audit Staff: The Auditing staff should be made familiar of the quality control policies and procedures of the firm. The hierarchy, responsibility & authority for decision making needs to be clearly defined and understood by the audit staff.

## Risk Assessment

### **Inherent Risk:**

Inherent risk is the susceptibility of a class of transaction to misstatement that could be

material, individually or when aggregated with misstatements in other transaction, assuming that there were no related internal controls. For example, Genuineness of the related party transactions.

### **Control Risk:**

Control Risk is the risk that a misstatement that could occur in an class of transactions and

that could be material individually or when aggregated with misstatement on other transaction, will not

be prevented or detected and corrected on a timely basis by the internal control systems. For example, delay in the filing of forms.

### **Detection Risk:**

Detection Risk is the risk that an auditor's substantive audit procedures will not detect a

misstatement that exist in class of transactions that could be material, individually or when aggregated with misstatement on other transaction. For example, while certification of e-form, the auditor has overlooked the compliance of the Secretarial Standards.

There is an inverse relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa, Auditor should take note of the inverse relationship between materiality and audit risk when determining the nature, timing and extent of audit procedures.

### ***COLLECTION OF INFORMATION/RECORDS OF AUDITEE***

The Audit team should

- ✓ Familiarize itself with
  - The operations and organisation of the auditee entity
  - The financial statement
  - The regulatory framework
  - The general legal framework governing the entity operations
- ✓ Understand the accounting processes and the degree of the technology involvement
- ✓ Access the overall control environment and in particular the control to prevent irregularity, illegality and fraud;
- ✓ Perform preliminary analytical procedures
- ✓ Analyze the financial statement in to account areas.

### ***PREPARATION OF AUDIT CHECKLIST***

**The benefits of the Audit checklists are as under:**

- a. Promote planning for the audit.
- b. Ensure a consistent audit approach.
- c. Act as a sampling plan and time manager.
- d. Serve as a memory aid.
- e. Provide a repository for notes collected during the audit process (audit field notes)

## COLLECTION AND VERIFICATION OF EVIDENCE

- Documents/Records scrutiny (already discussed)
- Testing, Interviews and Analysis (already discussed)
- Questionnaires (already discussed)
- Third party Confirmation.
- Analytical procedures

## *THIRD PARTY CONFIRMATION*

In such cases, a written request should be made to obtain the information. An external confirmation is audit evidence obtained as a direct written response to the Auditor from a third party in paper form, or through electronic or other medium.

## *ANALYSIS OF AUDIT EVIDENCE: 1. GATHERING 2. ANALYSIS 3. RE-ASSESSING RISK AND GATHERING EVIDENCE*

## *EXTERNAL EXPERTS' OPINION*

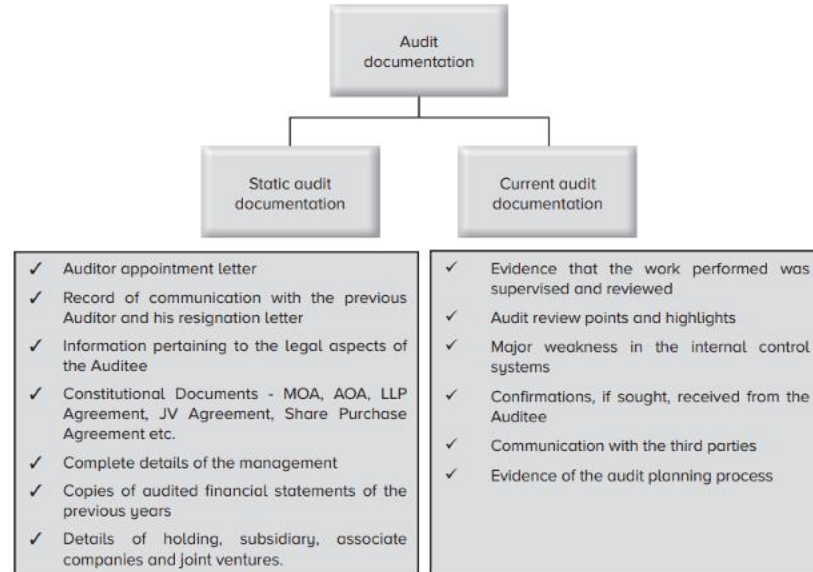
The auditor shall evaluate adequacy of expert's work having regard to the following:

- 1.Relevance and reasonableness of expert's findings/conclusions and consistency thereof with other audit evidence.
2. Relevance and reasonableness of assumptions and methods used in the expert's work.
- 3.Relevance, reasonableness, accuracy and completeness of source data (if any) used in the expert's work provided, such data are significant for the expert's Work.
- 4.Agreement with the expert on the nature and extent of further work by the expert in case expert's work is found to be inadequate for audit purpose.
- 5.Performance of additional, appropriate audit procedures in case expert's work is found to be inadequate for audit purpose.

# AUDIT DOCUMENTATION

Some of the broad characteristics of Audit Documentation are set out below :

|                                  |   |
|----------------------------------|---|
| Completeness and accuracy        | ● Provide support to audit conclusions  |
| Clarity and conciseness          | ● Facilitates understanding the entire audit process without need for any supplementary examination.  |
| Legibility and neatness          | ● Applies particularly to photocopies   |
| Ease of reference                | ● Working papers may be organised in volumes in a manner that facilitates easy reference  |
| Relevance                        | ● Working papers should be restricted to matters, which are important, pertinent and useful for the intended purpose  |
| Ease of review                   | ● Working papers should contain cross references to audit plan, discussion papers, audit observations, field audit report and the compliance audit report, as the case may be, to enable Auditor to link the working papers to audit findings and conclusions |
| Complete audit trail of analysis | ● Working papers should provide a complete trail of the audit procedures performed, evidence that were gathered and evaluated, audit findings and conclusions that were drawn.  |



# Lesson 12- Forming an Opinion and Reporting

## INTRODUCTION TO PROCESS OF FORMING AN OPINION

In particular, the auditor shall evaluate whether, in view of the requirements of the applicable reporting framework:

- (a) The Company has adequately disclosed information about its affairs;
- (b) The Company has followed the all procedure as required under the applicable laws;
- (c) The Company is in compliance with the applicable laws;
- (d) The Company is consistent with the applicable reporting framework;
- (e) The information presented by the company is relevant, reliable, comparable, and understandable; and
- (f) The company has provided adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information.

## FORMS OF OPINION

### Unqualified / Unmodified Opinion

An unqualified opinion is also known as a *clean opinion*. The auditor reports an unqualified opinion if the affairs of the company are presumed to be free from material misstatements.

An unqualified opinion contains no reservations concerning the company. This is also known as a “clean” opinion, meaning that the affairs of the company are presented fairly.

### Modified Opinion

The Auditor should express modified opinion when the Auditor concludes that:

- a. Based on the Audit Evidence obtained, there is **non-compliance** with the applicable laws in terms of timelines and process; or
- b. Based on the Audit Evidence obtained, the records as a whole are not free from **misstatement**; or are not maintained in accordance with applicable laws; or

c. He is **unable to obtain sufficient and appropriate Audit Evidence** to conclude that there is due compliance with the applicable laws in terms of timelines and process.

In case the Auditor expresses a modified opinion or disclaims an opinion, the text of the opinion shall be either in italics or bold letters.

The modification on Opinion can be in the following three categories depending upon the nature and severity/extremity of the matter under consideration:

- The qualified opinion
- The adverse opinion
- The disclaimer of opinion.

### Qualified Opinion

An Opinion can be considered as a qualified opinion when the auditor specifically provides the additional paragraph or points out the specific instances where the company has failed to do **compliance** as required under the law, or provides reasons for the not issuing the unqualified report on the affairs of the company

### Adverse Opinion

An Opinion can be considered as an adverse opinion, which is considered as the Out of track Opinion, wherein the auditor concluded that the **affairs of the company are not in line with its objectives, government rules**, and the company has neglected and grossly misstated its records.

An adverse opinion is an indicator of fraud, and public entities that receive an adverse opinion are forced to take corrective measures.

## Disclaimer of Opinion

An Opinion can be considered as an adverse opinion, which is considered as the Out of track Opinion, wherein the auditor concluded that the **affairs of the company are not in line with its objectives, government rules**, and the company has neglected and grossly misstated its records.

An adverse opinion is an indicator of fraud, and public entities that receive an adverse opinion are forced to take corrective measures.

## Third Party Report or Opinion

The Auditor should adhere to the following while forming an opinion based on third party reports or opinions:

1. The Auditor should indicate the fact of use of third party report or opinion and should also record the circumstances necessitating the use of third party report or opinion;
2. The Auditor should indicate the fact if third party report or opinion is provided by the Auditee;
3. The Auditor should consider the important findings/observation of third party;

## Opinion obtained by Management

In case where the information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:

- a. **Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information;**  
and
- b. **Evaluate whether the information is sufficiently precise and detailed for the purposes of the audit.**

## Evaluation of Audit Evidence and Forming Opinion

The Reliable audit evidence is evidence that is impartial, the reliability of audit evidence is dependent upon its nature, its source and the method used to obtain it. While collecting the audit evidence the auditor should consider that

- Documentary evidence is more reliable than oral evidence
- Evidence of which the auditor has direct personal knowledge is the most reliable evidence
- Independent evidence obtained from external sources is more reliable than internal evidence
- Visual evidence is highly reliable for confirming the existence of assets, but not their ownership value.
- Drawing conclusions solely through examining relationship between figures in the account (analytics Review) is less reliable evidence
- Oral evidence must be considered as the least reliable
- The reliability of information generated within the auditee entity is a function of the reliability of internal control systems within the entity.
- Photocopies are less reliable than the originals;
- Evidence, which is accepted by the auditee entity, is always reliable
- The auditor may gain increased assurance when audit evidence obtained from different source is consistent.

Different stages of communication and discussion should be as under:

|                       |  |
|-----------------------|--|
| 1. Preliminary Draft: | <b>At the conclusion of fieldwork, the auditor should draft the report and present it to the entity's management for auditee's comments.</b>   |
| 2. Exit Meeting:      | The auditor should discuss with the management the findings, observations, recommendations, and text of draft and obtain their comment on the draft, achieve consensus and reach an agreement on the audit findings. |
| 3. Formal Draft:      | The auditor should prepare a formal draft, in view of the outcome of the exit meeting and other discussions. Upon review of such changes by the auditor and the management, the final report should be issued.       |
| 4. Final Report:      | The report should be submitted to the appointing authority or such members of management, as directed.   |

If, after accepting the Audit Engagement, the Appointing Authority imposes a limitation on the scope of the audit which, in the opinion of the Auditor, is likely to result in the need to express a modified opinion or to disclaim an opinion, the Auditor shall request the Appointing Authority to remove the limitation.

If the Appointing Authority refuses or fails to remove the limitation, the Auditor shall communicate the matter to the Management and determine whether it is possible to perform alternative procedure to obtain sufficient and appropriate Audit Evidence.

If the Auditor is unable to obtain sufficient and appropriate Audit Evidence, the auditor shall determine the implications as follows:

- a. If the Auditor concludes that the possible effects of unavailable Audit Evidence could be nonmaterial, the Auditor shall qualify the opinion;  
or
- b. If the Auditor concludes that the possible effects of unavailable Audit Evidence could be material, the Auditor shall express disclaimer of opinion.

# MATERIALITY

Materiality is the threshold above which missing or incorrect information is considered to have an impact on the decision making of the Auditor. Information is considered as material if its omission or misstatement could influence the opinion of the Auditor.

The Auditor shall consider materiality while forming his opinion and adhere to:

1. **The principle of completeness** that requires the Auditor to consider all relevant Audit Evidence before issuing a report;
2. **The principle of objectivity** that requires the Auditor to apply professional judgement and professional skepticism that all reports are factually correct and that findings or conclusions are presented in a relevant and appropriate manner;

Threats to objectivity:

1. Self-interest threat
2. Self-review threat
3. Advocacy threat
4. Familiarity or trust threat
5. Intimidation threat

1. **The principle of timeliness** that implies preparing the report in due time; and
2. **The principle of a contradictory process** that implies checking the accuracy of facts and incorporating responses from concerned persons.

**Auditor's Report includes a separate section with heading "Auditor's Responsibility" that will state or express the opinion of the Auditor about the following:** – 1. Whether the audit has been conducted as per the **applicable Auditing Standards**. – 2. Whether the **Auditor has obtained reasonable assurance** about whether the statements prepared, documents or records maintained by the Auditee are free from misstatement. – 3. That Auditor has the responsibility to only **express his opinion on the evidences collected**, information received and records maintained by the Auditee or given by the Management. – 4. Whether the **Auditee has followed applicable laws**, act, rules or regulations in maintaining their records, documents, statements, or have complied with applicable laws or rules while performing any corporate action

## Pre requisite for the Reporting:

An Audit report should:

- **Accurate** -Free from errors and distortions and faithful to the underlying facts.
- **Objective** - Fair, impartial, and unbiased and is a result of a fair minded and balanced assessment of all relevant facts and circumstances.
- **Clear** - Easily understood and logical, avoiding unnecessary technical language and providing all significant and relevant information.
- **Concise** -To the point, avoid unnecessary elaboration, superfluous detail, redundancy, repetitiveness and wordiness.
- **Constructive** -Helpful to the engagement client and the organization and leads to improvements where needed.
- **Complete** -Lacking nothing that is essential to the target audience and includes all significant and relevant information and observations to support recommendations and conclusions.
- **Timely**-Opportune and expedient, depending on the significance of the issue, allowing management to take appropriate corrective action.

## Unit 15- Peer review and Quality Review

### Peer review for Company Secretaries

Peer review contemplates examination of the systems and approach of a Practice Unit (PU) by another member of the Institute with the objective of identifying the areas, where the practicing member may require guidance in improving the quality of his performance and adherence to the requirements of various technical standards.

### OBJECTIVES OF PEER REVIEW

The main objective of Peer Review is to ensure that in carrying out their Services, the PCS has complied with the Technical Standards laid down by the Institute and has in place proper systems (including documentation systems) for maintaining the quality of the Services/work they provide.

### Benefits of Peer Review

1. A successful Peer Review will provide **comfort** to the P.U. that he has adhered to various statutory, documentary and other regulatory requirements.
2. If deficiencies are noticed and **corrective measures** suggested, the P.U. will have an opportunity to correct the deficiencies and thereby enhance his professional competence.
3. If a Peer Review Certificate is issued in favour of the P.U. it enhances his **credibility** in the eyes of the general public.

### Qualifications for Peer Reviewer

The eligibility for become a Peer Reviewer needs to be a Member of the Institute who should—

- a) Possess at least 10 years of post-membership experience
- b) Be currently in whole time practice as a Company Secretary.

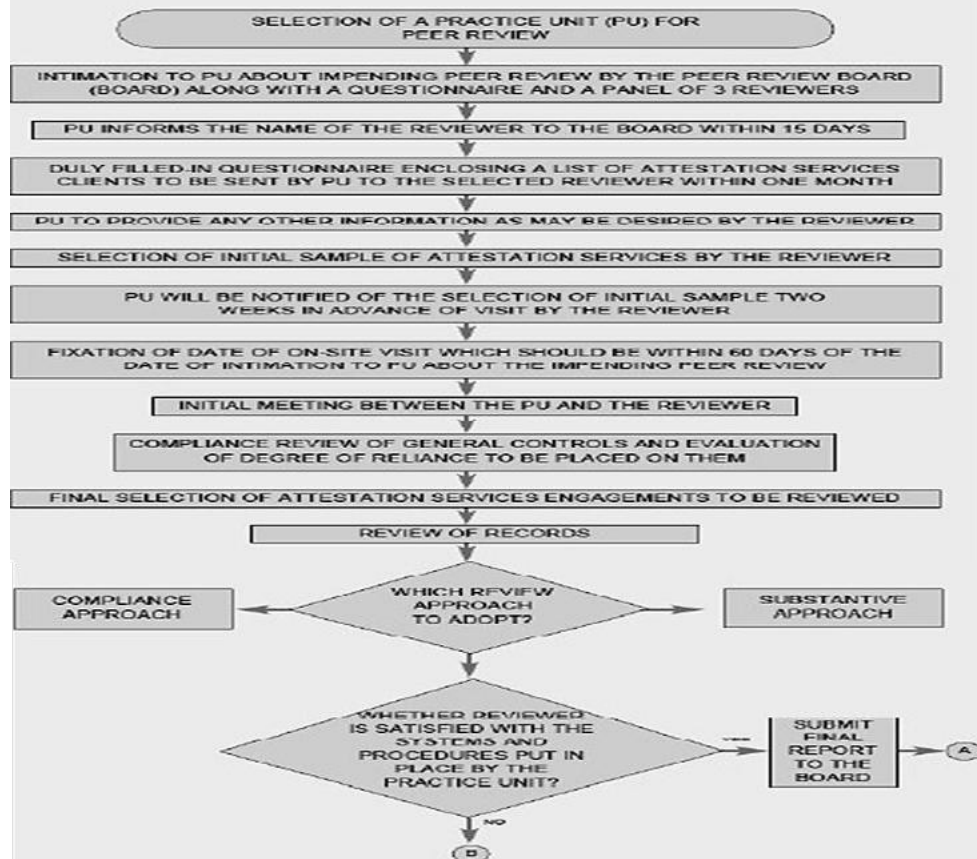
## **Scope of peer review + Guidelines for mandatory peer review services** - same list of unit 3 (list of certifications done by a PCS)

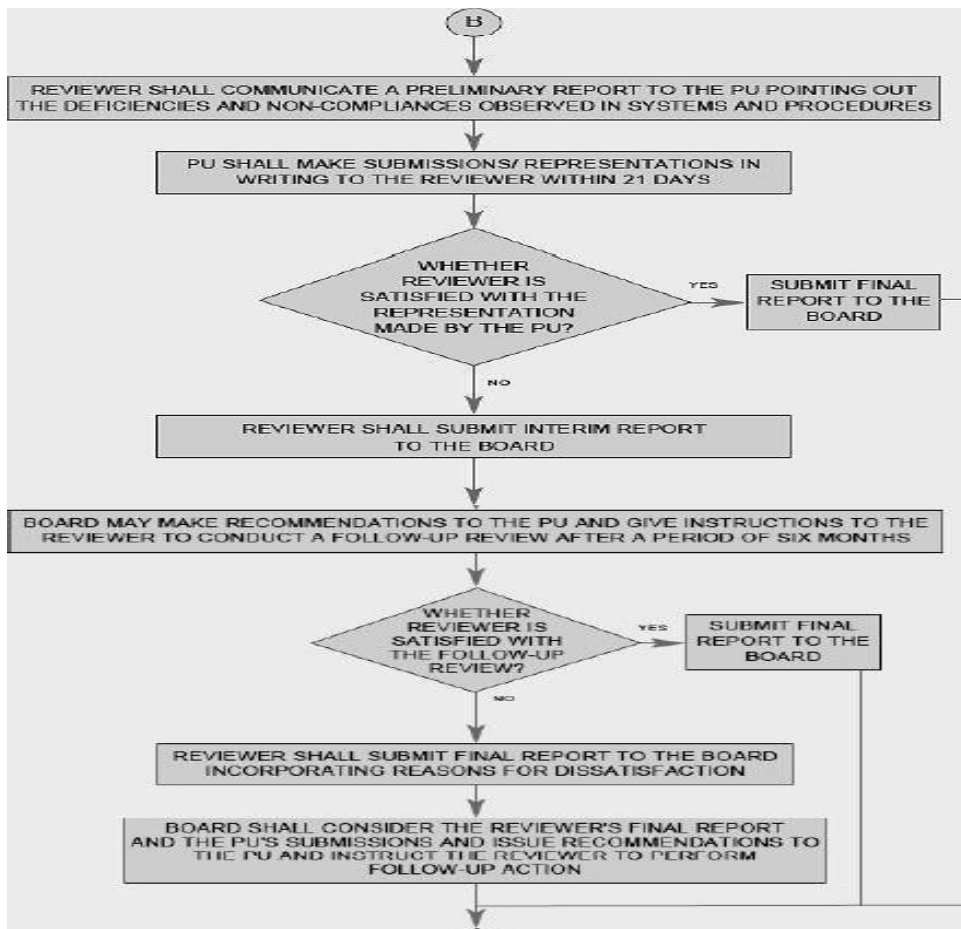
### *Expected Qualities of Reviewer*

The nature and complexities of peer review requires the exercise of professional judgment. The reviewer should:

- Be well acquainted with the technical aspects of the attestation services.
- Know the provisions of Code of Conduct of ICSI.
- Have studied various cases decided on Code of Conduct of ICSI.
- Get himself/herself acquainted with decisions of various courts on ‘cases relating to deficiency in service’.
- Be aware of relevant provisions of CS Act 1980, Consumer Protection Act, Evidence Act, IPC, etc.

## FLOW CHART EXPLAINING THE PEER REVIEW PROCESS







## Statement of Confidentiality

1. Shall at all times after their appointment preserve and aid in preserving secrecy 2. Shall not at any time communicate any such matter to any other person; and 3. Shall not at any time permit any other person to have any access to any record, document or any other material

## METHODOLOGY TO BE FOLLOWED BY REVIEWER

- (a) **Offsite review:** studying the information given by the PU in the Questionnaire and based on the same make his own observations about possible areas where improvement is possible
- (b) **Onsite review:** 1. *Verification of information given by the PU.* 2. *Test checks in respect of attestation assignments handled by the PU.* 3. *Interaction with the staff & trainees of PU should be a part of the peer review*

The cost of Peer Review for the reviewer and his qualified assistant(s) is decided by the Board from time to time, shall be borne by the Practice unit. In case reviewer has to conduct a second review, the same rate would apply to the second review also. Each of the branch/office under review would be considered as a separate unit for the purpose of payment of cost of Peer Review. Payment- 30 days

## Periodicity of Peer Review

The peer review of every practice unit should be mandatorily carried out at least once in a block of **5 years. 2 years** if reviewed with 2 years of incorporation

## *The Company Secretaries (Amendment) Act, 2006*

### **Section 29A. Establishment of Quality Review Board**

1. The Central Government shall, by notification, constitute a Quality Review Board consisting of a Chairperson and four other members.
2. The Chairperson and members of the Board shall be appointed from amongst the persons of eminence having experience in the field of law, economics, business, finance or accountancy.
3. Two members of the Board shall be nominated by the Council and other two members shall be nominated by the Central Government.

### **Section 29B. Functions of Board**

The Board shall perform the following functions, namely:—

1. To make recommendations to the Council with regard to the quality of services provided by the members of the Institute;
2. To review the quality of services provided by the members of the Institute including secretarial Audit services; and
3. To guide the members of the Institute to improve the quality of services and adherence to the various statutory and other regulatory requirements.

### **Section 29C. Procedure of Board**

The Board shall meet at such time and place and follow in its meetings such procedure as may be specified.

### **Section 29D. Terms and conditions of service of Chairperson and members of Board and its expenditure**

1. The terms and conditions of service of the Chairperson and the members of the Board, and their allowances shall be such as may be specified.
2. The expenditure of the Board shall be borne by the Council.

## Lesson 16 DUE DILIGENCE

**OVERVIEW OF DUE DILIGENCE-** “Due diligence” is an analysis and risk assessment of an impending business transaction. It is the careful and methodological investigation of a business or persons, or the performance of an act with a certain standard of care to ensure that information is accurate, and to uncover information that may affect the outcome of the transaction.

**OBJECTIVES OF DUE DILIGENCE-** The objective of due diligence is to verify the strategic identification or attractiveness of the target company, valuation, risk associated etc. The objective of due diligence may be to:

- ✓ Collection of material of information
- ✓ Identification of strength and threats and weaknesses.
- ✓ To improving the bargaining position.
- ✓ Identification of areas where representations and warranties are required.

The necessity of the due diligence can be summarized as under:

- To investigate in to the affairs of business as a prudent business person
- To confirm all material facts related to the business
- To access the Risks and opportunities of a proposed transaction
- To reduce the Risk of Post Transaction

- To create a trust between two unrelated parties
- To identify potential deal killers defected in the target and avoid a bad business transaction
- Representation & warranties for indemnification
- Negotiation price concessions
- To verify that the transaction complies with investment or acquisition criteria
- To investigate & evaluate a business opportunity
- To determine compliance with relevant laws and disclose any regulatory restrictions on the proposed transaction
- To evaluate the condition of the physical plant and equipment; as well as other tangible and intangible Assets
- To determine details that may be relevant to the drafting of the acquisition agreement,
- To discover liabilities or risks that may be deal-breakers
- To analyze any potential antitrust issues that may prohibit the proposed M&A .

### *SCOPE OF DUE DILIGENCE*

Due diligence is generally understood by the legal, financial and business communities/potential investors to mean the disclosure and assimilation of public and proprietary information, the investigation or inspection would cover:

- ✓ Compliance with applicable laws
- ✓ Regulatory violations or disciplinary actions
- ✓ Litigation and assessment of feasibility of pursuing litigation
- ✓ Financial statements
- ✓ Assets – real and intellectual property, brand value etc.
- ✓ Unpaid tax liens and/or judgments
- ✓ Past business failures and consequential debt
- ✓ Exaggerated credentials/Fraudulent claims

- ✓ Misrepresentations or character issues
- ✓ Cross-border issues – double taxation, foreign exchange fluctuation, sovereign risk, investment climate, cultural aspects.
- ✓ Reputation, goodwill and other intangible assets.

## ***FACTORS TO BE KEPT IN MIND WHILE CONDUCTING DUE DILIGENCE***

1. Objectives and purpose
  - (i) Be clear about your expectations in terms of revenues, profits and the probability of the target company to provide you the same.
  - (ii) Consider whether you have resources to make the business succeed and whether you are willing to put in all the hard work, which is required for any new venture.
  - (iii) Consider whether the business gives you the opportunity to put your skills and experience to good use.
  - (iv) Learn as much as you can about the industry you are interested in from media reports, journals and people in the industry.
2. Planning the schedule Once it is decided for a particular business, make sure of the following things: – Steps to be followed in due diligence process – Areas to be checked – Aspects to be checked in each area – Information and other material to be requested from the seller
3. Negotiation for time
4. Risk Minimisation
5. Information from external sources
6. Limit the report with only material facts
7. Structure of information Once the due diligence process is over, while preparing the report, information has to be structured in an organized manner in order to have a better correlation on related matters.

## STAGES / PROCESS OF DUE DILIGENCE

A due diligence process can be divided into three stages

|                             |   |
|-----------------------------|---|
| <b>1.Pre diligence</b>      | <p><b>A pre diligence is primarily the activity of management of paper, files and people.</b></p> <ol style="list-style-type: none"><li><b>1. Signing the Letter of Intent (LOI) and the Non-Disclosure Agreement (NDA)/ Engagement letter.</b></li><li><b>2. Receipt of documents from the company and review of the same with the checklist of documents already supplied to the company.</b></li><li><b>3. Identifying the issues.</b></li><li><b>4. Organising the papers required for a diligence.</b></li><li><b>5. Creating a data room.</b></li></ol> |
| <u>(ii) Diligence</u>       | <p>After the diligence, is conducted, the professionals submit a report, which in common parlance which is called as Due Diligence report. There are certain terms used to define the outcome of these reports:</p> <ul style="list-style-type: none"><li><input type="checkbox"/> Deal Breakers</li><li><input type="checkbox"/> Deal Diluters</li><li><input type="checkbox"/> Deal Cautioners</li><li><input type="checkbox"/> Deal Makers</li></ul>   |
| <u>(iii) Post Diligence</u> | <p>Post diligence sometimes result in rectification of non-compliances found during the course of due diligence. There can be interesting assignments arising out of the diligence made by the team of professionals. It can range from making applications/filing of petition for compounding of various offences or negotiating the shareholders' agreement, since the investors will be on a strong wicket and may negotiate the price very hard.</p>  |

## Pre diligence additional steps

### **Getting Ready Components of the Deliberative Overview**

- (a) Transaction Structure i.e. concerned parties, whether structured as share or asset purchase, tax considerations, restrictive covenants, etc.;
- (b) Transaction Funding i.e. how is funding contemplated and preliminary consideration of any significant issues in respect thereof;
- (c) Regulatory Issues such as restriction on foreign holding, subsidiaries, approvals, competition law issues and foreign exchange considerations;
- (d) International Aspects including the question of engaging overseas professional advisers;  
Timelines i.e. determination of time schedules for various stages of the contemplated Transaction;
- (e) Confidentiality Agreements i.e. whether Target seeks powers to restrict the release of certain information or data and review of covenants in relation thereto (Particularly in a listed company);
- (f) Exclusivity or Lock-In Arrangements as per negotiations between the parties;
- (g) Data Room Guidelines regarding the due diligence process on Target entity;

## TECHNIQUES OF DUE DILIGENCE AND RISK ASSESSMENT



## HUMAN RESOURCE DUE DELIGIENCE

Human Resource Due Diligence aims at people or related issues. Valuable operating synergies get disturbed, when cultural differences between companies aren't understood or are simply ignored. It's crucial to consider cultural and employees issues upfront, for success of any venture.

## **OPERATIONAL DUE DILIGENCE**

Operational due diligence aims at the assessment of the functional operations of the target company, connectivity between operations, technological up gradation in operational process, financial impact on operational efficiency etc.

Strategic due diligence- Strategic Due diligence tests the strategic rationale behind a proposed transaction and analyses whether the deal is commercially viable, whether the targeted value would be realized. It considers factors such as value creation opportunities, competitive position, critical capabilities.

## **FINANCIAL DUE DILIGENCE**

One of the most important types of due diligence as it seeks to check whether the financials showcased in the Information Memorandum is correct or not. The Financial Due diligence also review the company's projection and basis of such projections, capital expenditure plan, schedule of inventory, debtors and creditors, etc. The Financial Due Diligence can further extended to tax due diligence which covers the Diligence on various taxes the company is required to pay and which ensure that the proper calculation with no intention of underreporting of taxes. Status of any tax related case running with the tax authorities. The tax due diligence comprises an analysis of:

- Tax compliance
- Tax contingencies and aggressive positions
- transfer pricing
- Identification of risk areas
- Tax planning and opportunities

## ***ENVIRONMENTAL DUE DILIGENCE***

It involves risk identification and assessment with respect to:

- Review of the environmental setting and history of the site
- Assessment of the site conditions
- Operations and management of sites
- confirm legal compliance and pollution checks from regulatory authorities etc.

Technical due diligence can be classified in to

**Intellectual property due diligence** - The company which owns Intellectual Property (IPs) use that IPs to monetize their business. These IPs are something that differentiates their product and service from their competitors.

**Technology due diligence.** -

Technology due diligence considers aspects such as current level of technology, company's existing technology, further investments required etc. Technology is a key component of merger and acquisition activities; it's imperative to look at IT considerations.

## ***LEGAL DUE DILIGENCE***

A legal due diligence covers the legal aspects of a business transaction, liabilities of the target company, potential legal pitfalls and other related issues. Legal due diligence covers intra-corporate and intercorporate transactions. It includes preparation of regulatory checklists meeting with personnel, independent check with regulatory authorities etc.

## ***DUE DILIGENCE OF COMPETITION LAW***

Primary components of Competition Law due diligence are:

- An examination of selected company documents.
- Interviews with selected company personnel.
- Identify specific business activities that potentially could create antitrust exposure for the company.
- The results of the due diligence may suggest an enterprise to have an effective competition law compliance programme.
- The results of the due diligence may result in variation of deal value, withdrawal of deal and also make

## ***DUE DILIGENCE FOR MERGER & AMALGAMATION***

In case of the mergers and amalgamation of the companies, due diligence is a critical process which cannot be overlooked by the management as well as by the shareholders of the company while giving consent for the amalgamation. Due diligence in mergers not only requires the assessment of the financial, legal, and regulatory exposures, but also requires insights into the target company's structure, operations, culture, human resources, supplier and customer relationships, competitive positioning, and future outlook.

## ***DUE DILIGENCE FOR TAKE OVERS***

Takeover due diligence is useful in allowing the buyer to confirm his or her decision of the sale, or in negotiating the conditions of the sale. Because of this, it is necessary to find people experienced in due diligence, so that the audit acquisition will be effective and useful.

### **SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011**

The following Compliances are required to be checked under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011

1. Whether any acquisition/transfer has triggered **open offer**?
2. Ensure that a merchant banker of **Category i has been appointed** who is not an associate of or group of acquirer or the target company.
3. Ensure that an **escrow account has been opened** with the required deposit.
4. The **consideration** payable under the open offer shall be calculated at the offer price, assuming full acceptance of the open offer, and in the event the open offer is subject to differential pricing, shall be computed at the highest offer price, irrespective of manner of payment of the consideration. [computed as per sub regulation (2) of regulation 16]
5. A letter duly authorizing target company to **realize the value of escrow account** as specified in these regulations.
6. An undertaking from the target company that it has complied with the provisions of these regulations, and that any non-compliance or delayed compliance has been brought to the notice of Target Company.
- 7. A public announcement of an open offer**

## ***FCRA DUE DILIGENCE***

The FCRA, 2010 replaces the erstwhile Foreign Contribution (Regulation) Act of 1976. The FCRA legislation state that an organization cannot receive funding from a foreign source, unless it is registered under the Foreign Currency (Regulations) Act , 2010 or has obtained special government approval for a specific project. Also the registered NGOs need to comply with various post-registration requirements, as detailed in the provisions of the Act and its rules of enforcement. However, at the state level, an NGO can be registered as any of the following:

## ***NON DISCLOSURE AGREEMENT (NDA)***

- Society under the Registrar of Societies;
- To protect sensitive information. By signing an NDA, participants promise to not divulge or release information shared with them by the other people involved. If the information is leaked, the injured person can claim breach of contract.
- Public trust through the execution of a trust deed; or,
- Limited company under Section 8 of the Companies Act, 2013.
- In the case of new product or concept development, a confidentiality agreement can help the inventor keep patent rights. In many cases, public disclosure of a new invention can void patent rights. A properly drafted NDA can help the original creator hold onto the rights to a product or idea.
- Confidentiality agreements and NDAs expressly outline what information is private and what's fair game.

## ***Content of the Non-Disclosure Agreements***

### ***1. Definitions and exclusions of confidential information***

Definitions of confidential information spell out the categories or types of information covered by the agreement. This specific element serves to establish the rules-or subject/consideration-of the contract without actually releasing the precise information.

### ***2. Obligations from all involved people or parties; and time periods***

At the same time, nondisclosure agreements often exclude some information from protection. Exclusions might comprise information already considered common knowledge or data collected before the agreement was signed. Additionally, Time periods are also commonly addressed in NDAs and usually require that the party receiving the information stays mum for a number of years.

# Lesson 8- Concepts and Principles of Other Audits

## 1. CORPORATE GOVERNANCE AUDIT

Corporate Governance deals with conducting the affairs of a company such that there is fairness to all stakeholders and that its actions benefit the greatest number of stakeholders. It is about openness, integrity and accountability.

### **Scope of Audit of Corporate Governance Activities**

The scope of Corporate Governance Audit is wide and generally boundary-less, as the subject covers:

1. Financial and non-financial Information's and disclosures
2. Rights of Stakeholders;
3. Boards of Directors (Composition, mix, independence);
4. Control Environment (Accounting, Controls, Internal and External Audit);
5. Risk Management;
6. Transparency and Disclosure of financial information and executive compensation;
7. Strategic plans, programs and guidance on social responsibilities.

### **Role of Audit Committee w.r.to corporate governance has been defined under LODR Regulations as follows:**

- ✓ Oversight of the listed entity's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible;
- ✓ Recommendation for appointment, remuneration and terms of appointment of auditors of the listed entity;
- ✓ Approval of payment to statutory auditors for any other services rendered by the statutory auditors;
- ✓ Reviewing, with the management, the quarterly financial statements before submission to the board for approval;
- ✓ Reviewing, with the management, the statement of uses / application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice and the report

submitted by the monitoring agency monitoring the utilization of proceeds of a public or rights issue, and making appropriate recommendations to the board to take up steps in this matter;

- ✓ Reviewing and monitoring the auditor's independence and performance, and effectiveness of audit process;
- ✓ Approval or any subsequent modification of transactions of the listed entity with related parties;
- ✓ Scrutiny of inter-corporate loans and investments;
- ✓ Valuation of undertakings or assets of the listed entity, wherever it is necessary;

### **Illustrative Checklist for Auditing Corporate Governance System in a Company**

**(A) Accountability**

(B) Fairness

(C) Transparency

(D) Responsibility

(E) Shareholder Interests.

### **CORPORATE GOVERNANCE DUE DILIGENCE – COVERAGE**

The following aspects are to be analyzed during corporate governance due diligence. The list provided hereunder is not an exhaustive list.

**I. BOARD INDEPENDENCE & GOVERNANCE**

**II. BOARD SYSTEMS AND PROCEDURES**

**III. BOARD COMMITTEES**

**IV. TRANSPARENCY AND DISCLOSURE COMPLIANCES**

**V. CONSISTENT SHAREHOLDER VALUE ENHANCEMENT**

**VI. OTHER STAKEHOLDERS VALUE ENHANCEMENT**

**VII. CORPORATE SOCIAL RESPONSIBILITY**

## ***CORPORATE SOCIAL RESPONSIBILITY (CSR) AUDIT***

### **CSR under Companies Act, 2013**

- Section 135 of the Companies Act, 2013 provides that every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during the immediately preceding financial year shall
- constitute a Corporate Social Responsibility Committee of the Board consisting of three or more directors, out of which at least one director shall be an independent director;
  - adopt a CSR Policy in order to develop a sustainable CSR road map to help determine both compliance and social relevance with the Act.
  - spend, in every financial year, at least 2% of its average net profits made during the three immediately preceding financial years, in pursuance of its CSR policy.

### **Purpose of CSR Audit**

- To ensure compliance with the provisions of Companies Act, 2013 with respect to constitution of the Committee, adoption of policy and appropriate spending towards CSR activities.
- To facilitate transparent monitoring mechanism and a mentor for the Company's CSR activities and implementation of CSR policy.
  - To evaluate internal control and governance framework
  - To assess the project life cycle
  - To conduct financial review of projects to confirm the utilization of budgets for achieving desired outcomes.

### **Coverage of CSR Audit:**

- (i) Eradicating hunger, poverty and malnutrition, promoting health care including preventive health care and sanitation 4[including contribution to the Swach Bharat Kosh set-up by the Central Government for the promotion of sanitation] and making available safe drinking water

- (ii) Promoting education, including special education and employment enhancing vocation skills especially among children, women, elderly and the differently abled and livelihood enhancement projects.
- (iii) Promoting gender equality, empowering women, setting up homes and hostels for women and orphans; setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups.
- (iv) Ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agro forestry, conservation of natural resources and maintaining quality of soil, air and water 4[including contribution to the Clean Ganga Fund set-up by the Central Government for rejuvenation of river Ganga].
- (v) Protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional art and handicrafts;
- (vi) Measures for the benefit of armed forces veterans, war widows and their dependents;
- (vii) Training to promote rural sports, nationally recognized sports, Paralympics sports and Olympic sports
- (viii) Contribution to the prime minister's national relief fund or any other fund set up by the central govt. for socio economic development and relief and welfare of the schedule caste, tribes, other backward classes, minorities and women;
- (ix) Contributions or funds provided to technology incubators located within academic institutions which are approved by the central govt.
  - (x) Rural development projects.
  - (xi) Slum area development.

## ***TAKEOVER AUDIT***

The Takeover audit includes the compliances relating disclosure requirements (event based /continuous disclosures), Pricing, Open offer and verification of the compliance of various stage of takeover process etc., under the provision of the Companies Act, 2013 and the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. However the takeover audit primarily includes:

- Identify and Categories of acquirer i.e. Promoter, Promoter group, Person in control, Persons acting in concert, Associates, Immediate Relatives etc.
  - Ensuring that the timely disclosures have been made by promoters, members of Promoter Group and PACs relating to Acquisition, Transfer and encumbrance.
  - Effective Monitoring of the holdings of promoters, members of Promoter Group and PACs and take necessary action as required
  - Ensuring that timely intimation is sent to stock exchanges in respects of transfers exempt under SEBI (SAST) Regulations.
- Ensuring that timely reports are filed in respect of transfers exempt under SEBI (SAST) Regulations with Stock Exchanges and SEBI, if applicable.
  - Thoroughly examine the takeover regulations through checklist and timeline for compliances.

### **Consequences of Violation of obligations SEBI (SAST) Regulations, 2011**

SAST Regulations, 2011 have laid down the general obligations of acquirer, Target Company and the manager to the open offer. For failure to carry out these obligations as well as for failure / non-compliance of other provisions of these Regulations, penalties have been laid down there under. These penalties include:

- directing the divestment of shares acquired;
- directing the transfer of the shares / proceeds of a directed sale of shares to the investor protection fund;
- directing the target company / any depository not to give effect to any transfer of shares;
- directing the acquirer not to exercise any voting or other rights attached to shares acquired;
- debarring person(s) from accessing the capital market or dealing in securities;
- directing the acquirer to make an open offer at an offer price determined by SEBI in accordance with the Regulations;
- directing the acquirer not to cause, and the target company not to effect, any disposal of assets of the target company or any of its subsidiaries unless mentioned in the letter of offer;
- directing the acquirer to make an offer and pay interest on the offer price for having failed to make an offer or has delayed an open offer;

## **INSIDER TRADING AUDIT**

The Insider Trading audit includes the compliances requirements (event based /continuous disclosures) under the SEBI (Prohibition of Insider Trading) Regulations, 2015 which includes:

- Initial disclosures of trades which are to be made by only the promoters, key managerial personnel, directors internally;
- Continual disclosures which is to be made by every promoter, employee or director in case value of trade exceed monetary threshold of ten lakh rupees over a calendar quarter; company to accordingly notify stock exchanges within 2 trading days;
  - Submission of Trading Plans
  - Appointment of Compliance Officer
  - Pre-clearance for trading
  - Codes of Fair Disclosure and Conduct
  - Role of the Designate person
  - Manner of dealing with UPSI (unpublished price sensitive information)

## **CYBER AUDIT**

The objective of the cyber audit is to provide an assessment of the operating effectiveness of cyber security policies and procedures, identify, protect, detect, respond and recover processes and activities to the board.

The security and control issues which deals under cyber security audits includes

- ✓ Protection of sensitive data and intellectual property
- ✓ Protection of networks to which multiple information resource are connected
- ✓ Responsibility and accountability for the device and information contained in it

**Illustrative checkpoint on the Cyber Security Audit**

## **Personnel Security**

1. Whether the staff wears ID badges?
2. Whether it is a current picture part of the ID badge?
3. Are authorized access levels and type (employee, contractor, visitor) identified on the Badge?
4. Whether the credentials of external contractors are checked?
5. Whether the company has policies addressing background checks for employees and contractors?
6. Whether the Company has a process for effectively cutting off access to facilities and information systems when an employee/contractor terminates employment?

## **Physical Security**

1. Whether the Company has policies and procedures that address allowing authorized and limiting unauthorized physical access to electronic information systems and the facilities in which they are housed?
2. Whether the Company's policies and procedures specify the methods used to control physical access to your secure areas, such as door locks, access control systems, security officers, or video monitoring?
3. Whether the access to the computing area is controlled (single point, reception or security desk, sign-in/sign-out log, temporary/visitor badges)?

## **Account and Password Management**

1. Whether the Company has policies and standards covering electronic authentication, authorization, and access control of personnel and resources to your information systems, applications and data?
2. Whether the Company ensures that only authorized personnel have access to the computers?
3. Whether the Company requires and enforces appropriate passwords?
4. Are your passwords secure (not easy to guess, regularly changed, no use of temporary or default passwords)?

## **Confidentiality of Data**

1. Whether the Company is exercising responsibilities to protect sensitive data under their control?
2. Whether the most valuable or sensitive data encrypted?
3. Whether the Company has a policy for identifying the retention of information (both hard and soft copies)?

### **Confidentiality of Data**

1. Whether the Company is exercising responsibilities to protect sensitive data under their control?
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### **Compliance and Audit**

1. Whether the Company reviews and revises the security documents, such as: policies, standards, procedures, and guidelines, on a regular basis?
2. Whether the Company audits the processes and procedures for compliance with established policies and standards?
3. Whether the Company test the disaster plans on a regular basis?
4. Does management regularly review lists of individuals with physical access to sensitive facilities or electronic access to information systems.

## **ENVIRONMENT AUDIT**

An environmental audit from a financial perspective is conducted to ensure that public funds were spent efficiently and for their intended purposes. During an audit of financial statements related to environmental matters, the following issues will merit special attention:

- Initiatives to prevent, abate, or remedy damage to environment;
- Conservation of renewable and non-renewable resources; (Mentioned In Director's Report)
- Consequences of violating environment laws, rules and regulations;
- Consequences of vicarious liability imposed by the government, courts etc.

### **1. Environmental Compliance audits:**

Compliance audit with respect to environmental issues will relate to providing assurance that governmental and private companies' activities are conducted in accordance with the relevant laws, rules, notifications, regulations and standards as also policies and strategies.

## **Process of Environment Audit**

1. Understanding the industrial activity and Pre-audit or planning stage Collection of background information about the entity, definition of objectives and scope of audit, formation of audit team and development of audit plan and protocols.

### **2. On-site or Field Audit**

Communicate the objectives of the audit to key faculties and schedule necessary meetings and interviews, identify areas of concern, site / facility inspection, evidence / records / document review, staff interviews, initial review of findings.

### **3. Assessing the impact and post-audit**

Final evaluation of findings, submit preliminary report with type and magnitude of impact on the environment, get approval of management, introduce the findings to the auditees, submit final environment audit report along with short/ long term acceptability.

### **4. Follow up or review**

Verify the action taken on audit findings and recommendations.

## **CHECKLIST ON ENVIRONMENT AUDIT**

### **A. Environment Policy**

### **B. Environment Aspects**

1. Whether a procedure been established, implemented and maintained to identify the environmental aspects of its current and relevant past activities.
2. Whether aspects related to potential significant environmental aspects been considered in establishing and implementing the EMS.
3. Whether aspects having legal and/or regulatory reporting, monitoring or operational requirements been identified as “significant” aspects.

### **C. Legal and Other Requirements**

## FORENSIC AUDIT

Forensic audits are highly specialized, and the work requires detailed knowledge of fraud investigation techniques and the legal framework.

Forensic audit is done in two-phases.

**1. Investigation Services** – At first the auditor begins with an investigation; looking into the accounts and statement, and identifying defects in it. It then moves on to find ways to deal with such defects, which is a reactionary function.

### **2. Litigation Services** –

Their advice and consultation about the legalities of commercial disputes are very essential. Moreover, they also provide research assistance by giving relevant documents and facts to support a legal claim, and also help decide the extent of damage that is required. They are also called up by the Court as an expert witness for further investigation.

Forensic audits are done in following areas:

- Criminal investigations
- Professional negligence cases
- Arbitration cases
- Fraud investigation and risk /control reviews
- Settlement of insurance claims
- Dispute settlement

## PURPOSE OF FORENSIC AUDIT

### **I. Corruption**

### **II. Asset Misappropriation**

### **III. Financial statement fraud**

## **Procedure of Forensic Auditing Investigation Step 1 – Accepting the Investigation**

### **Step 2 – Planning the Investigation IV.Symptoms of Fraud**

#### **V.Internal Indicators**

#### **ILLUSTRATIVE CHECKLIST ON FORENSIC AUDIT:**

- Whether the fraud detected is at the management level or employee level?
- What was the reason or motive behind the fraud?
- How is the internal check on cash transactions, raising of invoices etc.? Who is responsible for the checking if all the things are in order in regular intervals?
- What is the nature of fraud – corruption, assets misappropriation or financial misstatement?
- Whether the entries passed are properly reflected in the Balance sheet without any omission?
- Whether IT returns are filed every year properly?
- Whether bank entries are reconciled on regular basis? Whether Bank statements do not have any discrepancy.

#### **Step 3 – Gathering Evidence Step 4 – Reporting**

#### **Step 5 – Court Proceedings**

## **SOCIAL AUDIT**

A social audit is a way of measuring, understanding, reporting and ultimately improving an organization's social and ethical performance. A

## **Objectives of Social audit**

1. Assessing the physical and financial gaps between needs and resources available for local development.
2. Creating awareness among beneficiaries and providers of local social and productive services.
3. Increasing efficacy and effectiveness of local development programmes.
4. Scrutiny of various policy decisions, keeping in view stakeholder interests and priorities, particularly of rural poor.
5. Estimation of the opportunity cost for stakeholders of not getting timely access to public services.
6. Provision of information needed to improve the effectiveness of programs designed to enhance community development.

## **CHECKLIST ON SOCIAL AUDIT:**

- Whether the Company has well defined policies for development of the society especially the poor and rural people?
- Whether on regular basis the scrutiny of fulfillment of the policy is done?
- Whether the physical and financial gaps between needs and resources available for local development are assessed on regular intervals?
- Whether the voices of the minority shareholders are considered? Are necessary actions taken over them?

# Lesson 9: Audit Engagement

## *MEANING OF AUDIT ENGAGEMENT*

## *APPOINTING AUTHORITY*

### **Terms and Conditions of Audit engagement**

- The objective and purpose of the audit
- The responsibilities of the auditor
- The responsibilities of management/ Auditee
- The Audit risk
- The Audit Limitation
- The Audit plan

## **The Responsibilities of Auditor**

1. To take up the audit as per the terms of the engagement.
2. To depute personnel who have the knowledge of the laws under which the audit is being carried out
3. To observe and ensure observance of highest standards of ethics and maintain utmost professionalism
4. To maintain and ensure confidentiality by the employees
5. To not trade in securities relating to which unpublished price sensitive information has come to his/ her knowledge during the course of audit,

## **Responsibilities of Auditee**

1. To provide access to premises of the Auditee and timely access to Records
2. To identify and depute a responsible official to timely provide relevant documents, information and explanations required by the Auditor.
3. To provide written Management representations, if any, to the Auditor during the course of audit,
4. To provide details of the Predecessor or Previous Auditor, so as to enable proposed Auditor to communicate with the Predecessor or Previous Auditor.

## **Communication to predecessor auditor**

**Communication by a letter sent by Registered Acknowledgement Due or by courier or by hand against the written Acknowledgement or through an email would be in the normal course provide such evidence. The Auditor shall wait for a period of 7 days from the date of communication before accepting the audit**

## **AUDIT FEE & EXPENSES**

Audit fee which is to be charge by the auditor depends on several factors, which includes:

- Size of the organization;
- Nature of business;
- Internal Controls systems & Technology adopted;
- Scope of audit;
- Frequency of audit etc.

## **INDEPENDENCE AND CONFLICT OF INTEREST**

Following are certain examples where an auditor shall assumed to have interested in the auditee's business or enterprise:

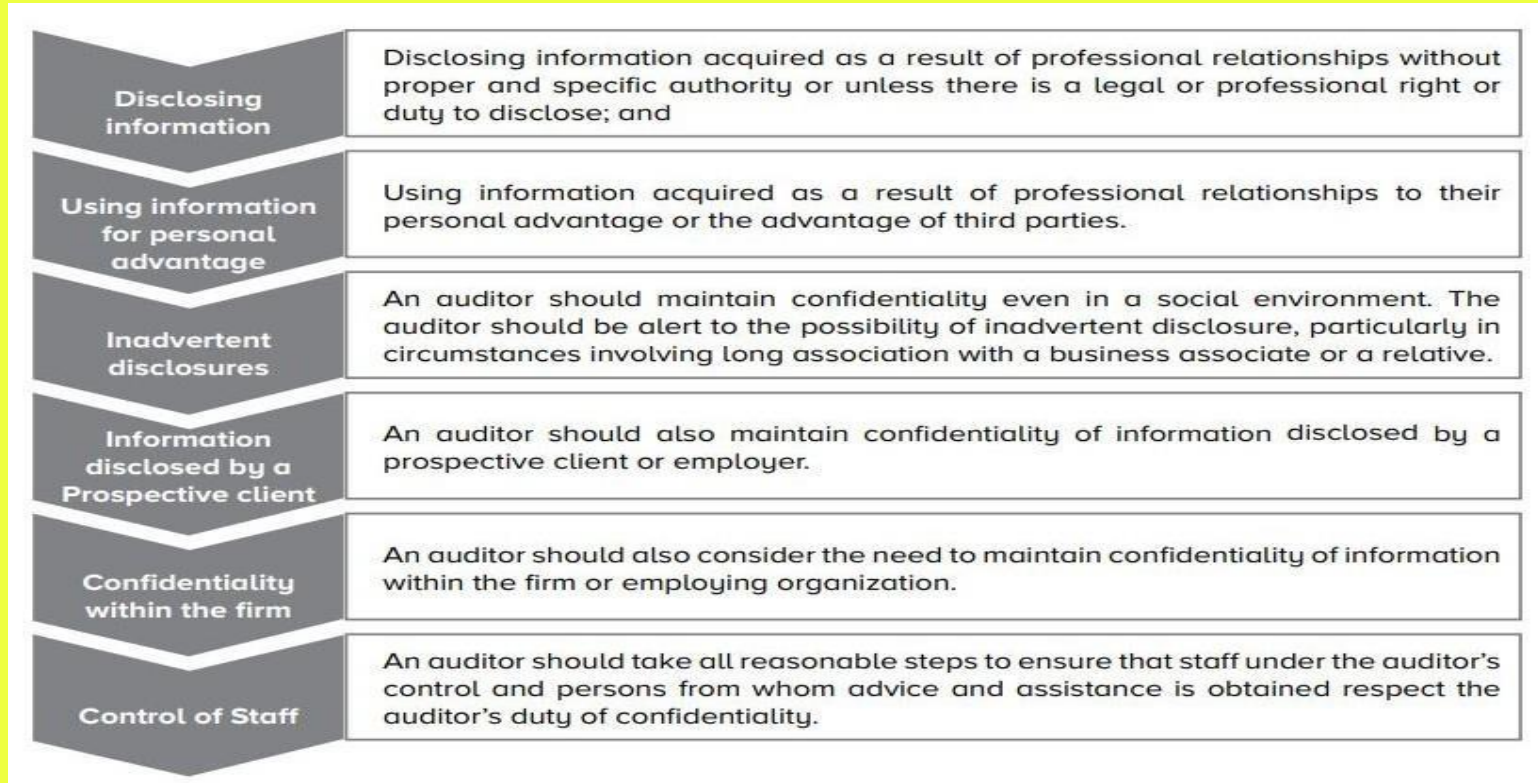
- 1.Holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.
- 2.Indebtedness to the company, or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

1. Has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.
2. Having business relationship (direct or indirect) with the company, or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.
3. Any relative of the auditor is a director or is in employment of the company as a director or key managerial personnel. The Company Secretaries Act, 1980 (the Second Schedule, Part I, paragraph 4) makes it an act of misconduct for a Company Secretary to express an opinion on any report or statement of a business or enterprise in which he or his firm or a partner of his firm has a substantial interest, unless he discloses the interest also in his report.

An auditor shall not allow a conflict of interest to compromise professional judgment. Examples of situations in which conflicts of interest may arise include:

- i. Providing a transaction advisory service to a client seeking to acquire an audit client of the firm, where the firm has obtained confidential information during the course of the audit that may be relevant to the transaction.
- ii. Auditing two clients at the same time who are competing to acquire the same company where the audit report might be relevant to the parties' competitive positions.
- iii. Taking audit assignment of two clients regarding the same matter, who are in a legal dispute with each other.
- iv. Providing an audit report for a licensor on royalties due under a license agreement when at the same time advising the licensee of the correctness of the amounts payable

# Principle of Confidentiality



## **Changes in terms of engagement**

, the Auditor should take the following precautions while accepting the change:

- (1) The Auditor should not agree to a change in the terms of the Audit Engagement which restricts the scope of audit provided under any statutes.
- (2) If the term of the Audit Engagement is changed when it is expected that Auditor may have to issue a modified report, such type of changes should be resisted.
- (3) Any request to change to avoid or circumvent unfavorable Auditor's report is also unjustified and should not be accepted.
- (4) If the terms of the Audit Engagement are changed before the completion of the audit, the Auditor should not disregard evidences obtained prior to the change in scope of audit.