
Unit 5 □ Audit of Limited Companies

Structure

- 5.0 Objectives**
- 5.1 Introduction**
- 5.2 Qualification of auditor**
- 5.3 Disqualification of auditor**
- 5.4 Procedure of appointment of auditor**
- 5.5 Reappointment of retiring auditor**
- 5.6 Ceiling on number of audits**
- 5.7 Remuneration of auditor**
- 5.8 Removal of auditor**
- 5.9 Power or Right of auditor**
- 5.10 Duties of auditor**
- 5.11 Branch audit**
- 5.12 Special audit**
- 5.13 Audit Report**
 - 5.13.1 Concept of Audit Report**
 - 5.13.2 Difference between Report and Certificate**
 - 5.13.3 Contents of Audit Report**
- 5.14 Types of Opinion / Types of Audit Report**
- 5.15 Independence of auditors**
- 5.16 The True and Fair View**
- 5.17 Concept of Materiality**
- 5.18 Divisible Profits and Dividend**

5.18.1 Divisible profit

5.18.2 Auditor duty regarding divisible profit

5.18.3 Dividend

5.19 Others

5.20 Questions

5.0 Objectives

After Studying this unit, you should be able to :

- Know the statutory requirements which are essential for the audit of limited companies.
- Understand the idea of audit report and its contents.
- Define the phrase ‘True & Fair’ and explain its relevance in the context of audit report.
- Explain the concept of dividend and divisible profits and the statutory requirements with respect to that.
- Interpret the concept of independence of auditor.

5.1 Introduction

A proper understanding of all the relevant provisions of the Companies Act, 1956 alongwith schedule VI and schedule XIV to the act affecting audit and accounts is essential to assess whether or not the balance sheet and profit and loss account disclose all the necessary information in the prescribed manner. Financial statements are prepared and presented to exhibit a true and fair view of the statement of affairs as well as profitability of the organisation. So emphasis has been given to explain the concept of true and fair view in the context of financial statements. The form of auditor’s report and its contents including specific matter, to be dealt with in the report are given in detail. Independence of auditor being one of the basic principles in audit is discussed as to its concept and present day importance. So, in this unit, all the important features of company audit are discussed.

5.2 Qualification of auditor

Section 226 of the Act provides that only a Chartered Accountant as defined in Chartered Accountants Act, 1949 can act as an auditor of a limited company. (Section 226 (1)). It is further provided that a firm where of all the partners are practising

chartered accountants can be appointed by its firm name as auditor in which case any partner may act in the name of the firm. Apart from practising chartered accountants, a holder of a certificate in an erstwhile Part B State which entitled him to act as an auditor of companies in the territories of that State immediately before November 1, 1956, is also entitled to be appointed as an auditor of companies registered anywhere in India. [Section 226 (2)].

As per Chartered Accountants Act, 1949 only a Chartered Accountant holding a certificate of practice can engage himself in the public practice of chartered accountancy.

So, under section 226 (1) and 226 (2) the following shall be qualified for appointment as auditor of a company.

1. A Chartered Accountant in practice.
2. A firm of practising chartered accountants.
3. A holder of certificate granted by any erstwhile Part B State. (more or less redundant)

However, such person, should not suffer from any of the disqualifications mentioned in Sub-sections (3) and (4) of section 226 of the Act and also should not hold audits within the limits specified in section 224 (1B) of the Act and those of notification, if any, issued by ICAI.

5.3 Disqualification of Auditor

Under section 226 (3), none of the following persons shall be qualified for appointment as auditor of a company :

1. A body corporate.
2. An officer or employee of the company
3. A person who is a partner or who is in the employment, of an officer or an employee of the company.
4. A person who is indebted to the company for an amount exceeding rupees one thousand or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding rupees one thousand.
5. A person holding any security (i.e. instrument having voting rights) of the company.

Section 226 (4) provides that a person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

Further section 226 (5) provide that if, after his appointment, an auditor becomes subject to any of the disqualifications listed above, he shall be deemed to have vacated his office as such.

5.4 Procedure of appointment of auditors

Section 224 of the Companies Act contains the provisions relating to the appointment of auditors of a company. The appointment of auditors of a company may be discussed in the following ways :

(a) Appointment of first auditor :

Section 224 (5) states that the first auditor or auditors of a company shall be appointed by the Board of Directors within one month of the date of registration of the company and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting.

However, a company may, at a general meeting, remove any such auditor or auditors and appoint in his or their places any other persons or persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting. This means first auditor can be removed at any general meeting prior to the first annual general meeting. Special notice is not required for that.

Section 224 (5) (b) provides that if the Board of Directors fails to appoint the first auditor, the company at a general meeting may do so.

(b) Subsequent appointment of auditors

Section 224 (1) provides that every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed. As per Section 224 (1A), every auditor so appointed must, within 30 days of the receipt from the company of the intimation of his appointment, inform the Registrar in writing that he has accepted or refused to accept the appointment.

(c) Filling casual vacancy

Section 224 (6) provides that the Board of Directors may fill any casual vacancy (death, disqualification etc.) in the office of an auditor, but while any such vacancy continues, the remaining auditor or auditors, if any may act.

It is also provided that where casual vacancy is caused by the resignation of an auditor, the vacancy shall only be filled by the company in the general meeting.

Section 224 (6)(b) provides that an auditor appointed in a casual vacancy shall hold office until the conclusion of the next general meeting.

(d) Appointment by Central Government

Section 224 (3) provides that where at an annual general meeting no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. For that the company shall within seven days of the Central Government's power under sub-section (3) becoming exercisable, give notice of that fact to the government.

When an auditor is required to be appointed at an annual general meeting by a special resolution but the company omits or fails to pass such resolution due to any reason, it shall be deemed that no auditor has been appointed by the company at its general meeting and the provisions of section 224 (3) will be applicable. Again where auditors are not appointed or re-appointed at the annual general meeting in accordance with the provisions of the law (sections 188, 190 or section 225), the Central Government shall be eligible to appoint the auditor.

(e) Appointment of auditors by Special Resolution

Section 224A of the Act provides that in the case of a company in which not less than 25% of the subscribed share capital is held, whether singly or in any combination, by—

(a) a public financial institution or a government company or central government or any state government, or

(b) any financial or other institution established by any provincial or state Act in which a state government holds not less than 50% of the subscribed share capital, or

(c) a nationalised bank or an insurance company carrying on general insurance business.

the appointment or re-appointment at each general meeting of an auditor or auditors shall be made by a special resolution.

If at an annual general meeting the company omits or fails to pass a special resolution appointing an auditor or auditors, it shall be deemed that no auditor or auditors had been appointed there at. Therefore, the central government may appoint any person to fill the vacancy.

(F) Appointment of auditors of Government Companies

Section 619 of the Act provides that the auditor of government company shall be appointed or re-appointed by the Comptroller and Auditor-General of India (C & AG). According to 619B, the provisions of 619 of the Act shall also apply to a company in which the Central Government or any State Government or any Government Company or any Government Corporation held either singly or jointly not less than 51% of the paid up share capital. Thus, the auditors of such companies are to be appointed by C & AG.

5.5 Reappointment of retiring auditor

Section 224 (2) provided that subject to section (1B) regarding ceiling of audits and section 224A, regarding appointment of auditors by special resolution in certain cases, at any general meeting, a retiring auditor, by whatever authority appointed shall be re-appointed unless :

(a) he is not qualified for re-appointment; or

(b) he has given to the company notice in writing of his unwillingness to be re-appointed; or

(c) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be re-appointed; or

(d) where notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, but owing to that persons death, incapacity or disqualification the resolution cannot be proceeded with and so must be dropped.

5.6 Ceiling on number of audits

According to section 224 (1B), no company or its Board of Directors shall appoint or re-appoint any person (who is in full time employment elsewhere) or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as an auditor of the specified number of companies or more than the specified number of companies. (excluding private limited companies).

Specified number for this purpose means–

(a) in the case of a person or firm holding appointment as auditor of a number of companies each of which has a paid-up share capital of less than rupees 25 lakhs, twenty such companies.

(b) in any other case, twenty companies, out of which not more than ten shall be companies each of which has a paid-up share capital of Rs. 25 lakhs or more.

5.7 Remuneration of auditors

Section 224 (8) of the Companies Act provides that–

(1) In the case of first auditor or auditors appointed by it to fill a casual vacancy the Board of Directors can fix the remuneration.

(2) If the auditor is appointed by the central government that it may fix the remuneration.

(3) If the auditor is appointed by the company at its general meeting or he is appointed under section 619 by C & AG, the remuneration shall be fixed by the company at the general meeting or in such manner as the company in general meeting may determine.

As per schedule VI of the Companies Act separate disclosure of all the amounts paid to an auditor is required to be made in the profit & loss A/c as follows :

(a) As auditor

(b) As advisor or in any other capacity in respect of–

(i) Taxation matters

(ii) Company law matters and

(iii) Management services

(c) Other amounts paid in any other manner.

It is important to mention here that in case of specified entities, the total fees for

‘other assignments’ from such an entity for a financial year cannot exceed its statutory audit fees and a statutory auditor can not do the internal audit of the same enterprise.

5.8 Removal of auditors

Section 224 (5) provides that the first auditor appointed by the Board of Directors may be removed at a general meeting by the company before the expiry of his term without the central governments prior approval. In this case, a special notice of at last 14 days is required for the appointments of any other person in his place.

Section 224 (7) states that any auditor, appointed (i) in an annual general meeting or (ii) by the Board to fill a vacancy, or (iii) appointed by the central government may be removed from office before the expiry of his term only by the company in general meeting, after obtaining previous approval of the central government in that behalf.

In all cases of removal of auditors before the expiry of their term, the provisions of section 225 shall apply.

At the expiry of his term, the company may in general meeting appoint another person in his place, but a special notice of any such resolution is necessary and also the provisions of sections 225 (2) and 225 (3) shall apply.

5.9 Powers or Rights of auditor

To enable the auditors to perform his task effectively the following rights have been given to them by the Companies Act.

1. He has right of access to all books, accounts and vouchers of the company at all times notwithstanding whether these are kept at its head office or elsewhere (Sec. 227).

2. Section 227 (1) of the act entitles the auditor of a company to require from the officers of the company such information and explanations as the auditor may think necessary for the performance of his audit as auditor.

Section 221 makes it obligatory for the officers of a company to furnish without delay the relevant information to the auditor.

3. Section 228 (2) provides that the auditor of a company has the right to visit branch offices and to have access to the books, accounts and vouchers maintained at the branch office both with some restrictions in the case of foreign branches of a banking company.

4. He has the right to attend any general meeting of the company and can make statements on any part of the business, which concerns him as auditor (Sec. 231).

5. He has the right to make comment upon the affairs of the company on the basis of the accounts audited by him.

6. He can authenticate the documents and returns of the company required to be certified by the auditor under the Companies Act 1956 (i.e. Statutory Report etc.)

7. He has a right to receive his remuneration (Sec. 224)

5.10 Duties of auditor

An auditor owes a number of duties to the company and to its members. The duties of an auditor are as follows :-

1. Duty to certify Profit and Loss Account in a prospectus (Section 56) :

A prospectus issued by an exiting company contains a statement showing profits and losses, assets and liabilities of a company and rate of dividends paid by it each year in the 5 financial years preceding the issue of the prospectus. This statements has to be certified by the auditor of the company.

2. Duty to certify the Statutory Report (Sec 165) :

An Auditor has to certify the corrections of the Statutory Report in resepect of the number of share allotted by the company, the total amount of cash received by the company by allotment of shares and abstract of receipts and payments of the company.

3. Duty to make report (Sec 227)

The auditor shall make a report to the members of the company on the accounts examined by him.

The report should contain an opinion as to whether or not the balance sheet and profit and loss account exhibit a true and fair view of the state of affairs as well as profitability of the organisation respectively. Apart from expressing this opinion certain other assertions are also required to be included in the company auditors report under the provisions of sub-section (2), (3), (1A) and (4A) of section 227 of the Act (discussed later under audit report).

4. Duty to assist the investigator (Section 240)

An auditor is required to produce before an inspector appointed under sectoin 235 of the Companies Act, 1956, all papers and books of the company which are in his custody and should also assist him in such investigation.

5. Duty of a Branch Auditor.

Under section 228, the branch auditor has to prepare a report on the accounts of the branch examined by him and forward the same to the company's auditor who is to deal with the same in such manner as he considers necessary.

Duty as per section 227 (4).

6. Section 227 (4) provides that if any of the matters in the auditors report is answered in negative or with a qualification the auditors report shall also state the reason for such an answer.

7. Duty to know his duties under Articles.

It is the duty of an auditor to make himself acquainted with his duties under the Articles of a company.

8. Duty to exercise reasonable care and skill :

An auditor should exercise reasonable care and skill in discharging his duties.

9. An auditor is also required to certify cashflow statement and compliance of corporate governance requirements as per clause 32 and clause 49 of listing agreements respectively under SEBI Act.

10. An auditor also certifies the return of deposits to be filed with registrar by a company as per rule 10 of Companies (Acceptance of deposit) Rules, 1975.

5.11 Branch audit

Section 228 of the Companies Act provides that the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. If any branch office of the company is outside India, the accounts shall be audited by a person qualified to audit accounts according to the laws of that country or the company's auditor or a person qualified for appointment as auditor under the companies Act, 1956. When a company decides at its general meeting that accounts of a branch office will be audited other than the company's auditor, in that case the appointment of the branch auditor may either be made by the company in that general meeting or the board of directors may be authorised to appoint the branch auditor in consultation with the company's auditor.

The terms and conditions of the appointment and the remuneration of such auditor is either fixed by the company in the general meeting or by the board of directors if so authorised by the company in general meeting.

The branch auditor shall have the same powers and duties in respect of the branch audit as the company's auditor. He shall submit his report to the company's auditor.

Sub-section (4) of section 228 empowers the Central Government to make rules regarding the exemption of any branch office from the aforesaid provisions to the extent specified in the rules.

5.12 Special Audit

Under section 233A of the Companies Act, 1956 the central government is empowered to order a special audit of the accounts of a company for a specified period in certain circumstances.

The central government may at any time by order direct a special audit of the company's accounts if it is of opinion that :

(a) the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices, or

(b) the company is being managed in a manner likely to cause serious injury or

damage to the interests of the trade, industry or business to which it pertains; or

(c) that the financial position of any company is such as to endanger its solvency.

The central government may appoint either the company's auditor or any other chartered accountant as defined in section 2 (1)(b) of the Chartered Accountants Act, 1949 whether or not such Chartered Accountant is in practice.

The remuneration of special auditor should be determined by the central government and paid by the company.

The special auditor has the same powers and duties as a company auditor has under section 227 of the Companies Act with only one exception that he has to make the report to the central government instead of making his report to the members of the company containing all information as required under section 227 of the Companies Act and also information on any other matter as may be referred to the special auditor by the government.

5.13 Audit Report

5.13.1 Concept of Audit Report

The audit report is absolutely fundamental to the audit. The whole purpose of all the procedures carried out during the audit is to enable the auditors to express their opinion in their report to the members. It is the end product of every audit. Thus audit report declares the medium through which an auditor expresses his opinion on the financial statements or other data under audit.

5.13.2 Difference Between Report and Certificate

A report is a formal statement normally made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon.

A certificate, on the other hand, is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion.

5.13.3 Contents of Audit Report

A. As per AAS-28 :

An audit report generally states the scope of the audit and opinion of the auditor : AAS 28, 'The Auditor's Report on Financial Statements', establishes standards on the form and contents of the auditor's report. According to the standard, the basic elements of the auditor's report are as follows :

1. Title

An appropriate title such as "Auditor's Report" helps to identify the report and to distinguish it from other reports.

2. Addressee

The report should be properly addressed as required by the terms of engagement and applicable laws and regulations. In the case of statutory audit of a company, the report is addressed to the shareholders.

3. Opening or Introductory Paragraph

This consists of–

(i) Identification of financial statements

The financial statements should be identified by including the name of the entity and the date of, and period covered by, the financial statements.

(ii) Responsibility

The opening paragraph should also state that the financial statements are the responsibility of the entity's management and the responsibility of the auditor is to express an opinion thereon.

4. Scope

The auditors report should describe of the scope of the audit of stating that the audit was conducted in accordance with auditing standards generally accepted in India (as per AAS) and that the audit was planned and performed to obtain reasonable assurance whether the financial statements are free of material misstatement.

The auditors report should describe the audit as including :

(a) examining, on a test basis, evidence to support the amounts and disclosures in financial statements :

(b) assessing the accounting principles used in the preparation of the financial statements;

(c) assessing the significant estimates made by management in the preparation of the financial statement; and

(d) evaluating the overall financial statement presentation.

The report should include a statement by the auditor that the audit provides a reasonable basis for his opinion.

5. Opinion Paragraph

The auditors report should clearly indicate the financial reporting framework (relevant statutory requirements like Companies Act for Companies, AS and other recognised accounting principles and practices) used to prepare the financial statements and state the auditors opinion as to whether the financial statements give a true and fair view in accordance with that financial reporting framework and where appropriate, whether the financial statements comply with the statutory requirements.

In addition to an opinion on the true and fair view, the auditors report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant matters or law such as Companies Act in case of company.

6. Signature

The report should be signed by the auditor in his personal name. Where a firm is

appointed as auditor, the report should be signed in the personal name of the auditor and in the name of the audit firm. The partner / proprietor signing the audit report should also mention the membership number assigned by ICAI.

7. Place of signature

The report should have a specific location, which is ordinarily the city where the audit report is signed.

8. Date of the report

The date of the auditors report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statement. Since the auditors responsibility is to report on the financial statement as prepared and presented by management the auditor should not date the report earlier than the date on which financial statements are signed or approved by management.

B. As per Companies Act, 1956

As per the relevant provisions of the Companies Act the contents of the audit report in respect of a company are the following :

1. Section 227 (2) provides that the auditor should make a report to the members of the company on the accounts examined by him, and on every balance sheet and profit and loss Account and other relevant documents and his report should state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in the manner so required and give a true and fair view—

(i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and

(ii) in the case of the profit and loss account, of the profit or loss for its financial year.

2. The auditors report should also state—

(a) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books, and receipt of returns are adequate relating to the branches not visited by him.

(bb) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (d) of sub-section (3) of that section and how he has dealt with the same in preparing the auditors report.

(c) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

(d) whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;

(e) In thick type or italics the observations or comments of the auditors which have any adverse effect on the functioning of the company;

(f) whether any director is disqualified from being appointed as director under clause (g) of sub section (1) of section 274.

(g) whether the cess payable under section 441A has been paid and if not, the details amount of cess not so paid.

(3) Section 227 (4) provides that whether any of the matters as referred to in clause (i) and (ii) of sub-section or in clauses (a), (b) (bb) (c) and (d) of sub-section 3 is answered in the negative or with or qualification, the auditors report should state the reason for the answer.

(4) Section 227 (1A) provides the auditor has to make an enquiry in respect of the following matters and he has to report only if he is not satisfied with the results of his enquiry.

Clause (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members.

Clause (b) whether transactions of the company which are represented merely by book entry are not prejudicial to the interests of the company;

Clause (c) whether the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.

Clause (d)–whether loans and advances made by the company have been shown as deposits.

Clause (e)–whether personal expenses charged to revenue account

Clause (f)–where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

(5) In accordance with the provisions of section 227 (4A) of the Companies Act the central government has issued a revised order in 2003, viz. The Companies (Auditor's Report) order 2003. (CARO '03). This order supercedes the earlier order known as MAOCARO '88.

The provisions of this order are in addition to the directions of the Comptroller and Auditor General under section 619 of the Act in respect of audit of government companies.

The specified matters that are required to be dealt with in the auditor's report under section 227 (4A) are given below :

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

- in the books of account;
- (c) if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern;
- (ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management;
- (b) are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported;
- (c) whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account;
- (iii) (a) has the company either granted or taken any loans, secured or unsecured to / from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions.
- (b) whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company;
- (c) whether payment of the principal amount and interest are also regular;
- (d) if overdue amount is more than one lakh, whether reasonable steps have been taken by the company for recovery / payment of the principal and interest;
- (iv) is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods. Whether there is a continuing failure to correct major weakness in internal control;
- (v) (a) whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered;
- (b) whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time; (This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year).
- (vi) in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A and 58AA of the Act and the rules framed thereunder, where applicable, have been complied with. If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board whether the same has been complied with or not?

- (vii) In the case of listed companies and / or other companies having a paid-up capital and reserves exceeding Rs. 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned; whether the company has an internal audit system commensurate with its size and nature of its business;
- (viii) where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained;
- (ix) (a) is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Custom Duty, Excise Duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.
 (b) in case dues of sales tax / income tax / custom tax / wealth tax / excise duty / cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may please be mentioned. (A mere representation to the Department shall not constitute the dispute.)
- (x) whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the financial year immediately preceding such financial year also;
- (xi) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;
- (xii) whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.
- (xiii) whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi / mutual benefit fund / societies;
 - (a) whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;
 - (b) whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard / doubtful / loss assets;
 - (c) whether the company has adequate procedures for appraisal of credit proposals/ requests, assessment of credit needs and repayment capacity of the borrowers;

- (d) whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower and would be conducive to recovery of the loan amount;
- (xiv) if the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other securities have been held by the company, in its own name except to the extent of the exemption, if any, granted under section 49 of the Act;
- (xv) whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company;
- (xvi) whether term loans were applied for the purpose for which the loans were obtained;
- (xvii) whether the funds raised on short-term basis have been used for long term investment and vice versa. If yes, the nature and amount is to be indicated;
- (xviii) whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company;
- (xix) whether securities have been created in respect of debentures issued?
- (xx) whether the management has disclosed on the end use of money raised by public issues and the same has been verified;
- (xxi) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Where, in the auditor's report, the answer to any of the questions referred above is unfavourable or qualified the auditor's report shall also state the reasons for such unfavourable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

Audit report of two companies are given below for case study :

To the member of
Indian Aluminium Company Limited

1. We report that we have audited the attached Balance Sheet of Indian Aluminium Company Limited as at 31st March, 2002 and also the Profit and Loss Account for the year ended on that date annexed thereto both of which we have signed under reference to this report. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

2. We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as, evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
3. In our opinion and to the best of our information and according to the explanations given to us, the said accounts together with the notes thereon and attached thereto and the Statement on Significant Accounting Policies give in the prescribed manner the information required by the Companies Act, 1956, of India (the Act), and also give respectively, subject to the Note on Schedule 31 regarding remuneration of Managing Director, Operations awaiting Shareholders' approval to the extent indicate therein, a true and fair view in conformity with the accounting principles generally accepted in India :
 - (a) in the case of the Balance Sheet, of the state of affairs of the Company as at 31st march, 2002 and
 - (b) in the case of the Profit and Loss Account, of the profit for the year ended on that date.
4. We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion, proper books of account have been kept by the Company as required by law so far as appears from our examination of these books and the aforementioned Balance Sheet and Profit and Loss Account are in agreement therewith.
5. In our opinion, these accounts have been prepared in compliance with the applicable Accounting Standards referred to in Section 211 (3C) of the Act.
6. On the basis of written representations received from the directors, as on 31st March, 2002 and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March, 2002 from being appointed as a director in terms of clause (g) of sub-section (1) of Section 274 of the Act.
7. As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988 dated 7th September 1988 issued by the Government of India in terms of sub-section (4A) of Section 227 of the Act and on the basis of such checks as we considered appropriate and according to the information and explanations given to us, we further report that :
 - i. (a) The Company has maintained proper records to show full particulars including quantitative details and situation of its fixed assets.
 - (b) The fixed assets of the Company are physically verified by the management

- according to a phased programme designed to cover all the items over a period of three years. Pursuant to the programme, a physical verification was carried out during the year and this revealed no material discrepancies.
- ii. The fixed assets of the Company have not been revalued during the year.
 - iii. The stocks of finished goods, stores, spare parts and raw materials of the Company at all its locations have been physically verified by the management during the year.
 - iv. In our opinion, the procedures of physical verification of stocks followed by the management are reasonable and adequate in relation to the size of the Company and the nature of its business.
 - v. The discrepancies between the physical stocks and the book stocks which have been properly dealt with in the books of account were not material.
 - vi. In our opinion the valuation of stocks of finished goods, stores, spare parts and raw materials has been fair and proper in accordance with the normally accepted accounting principles in India and is on the same basis as in the preceding year.
 - vii. The Company has not taken any loans, secured or unsecured from companies, firms or other parties listed in the Register maintained under Section 301 of the Act.
 - viii. The Company has not granted any loans secured or unsecured to companies, firms or other parties listed in the Register maintained under Section 301 of the Act.
 - ix. The parties to whom loans or advances in the nature of loans have been given by the Company are repaying the principal amounts as stipulated and are also regular in payment of interest, where applicable.
 - x. In our opinion, there is an adequate internal control procedure commensurate with the size of the Company and the nature of its business, for purchase of stores, raw materials including components, plant and machinery, equipment and similar assets and for the sale of goods.
 - xi. The Company has not purchased goods and materials and sold goods, material and services aggregating Rs. 50,000/- or more in value from / to any of the parties listed in the Register maintained under Section 301 of the Act.
 - xii. The Company has a system of determining unserviceable or damaged stores, raw materials and finished goods on the basis of technical evaluation and on such basis, in our opinion, adequate amounts have been written off such stock in the accounts.
 - xiii. In the case of public deposits accepted by the Company, the directives issued by the Reserve Bank of India and the provisions of Section 58A of the Act and the rules framed thereunder have been complied with.
 - xiv. In our opinion, reasonable records have been maintained by the Company

- for the sale and disposal of realisable by-products and scrap, where applicable and significant.
- xv. In our opinion, the Company's present internal audit system is commensurate with its size and the nature of business.
- xvi. On the basis of the records produced, we are of the opinion that, prima facie, the cost records and accounts prescribed by the Government of India under Section 209(1) (d) of the Act have been maintained. However, we are not required to and have not carried out any detailed examination of such accounts and records.
- xvii. The Company has regularly, deposited during the year, the Provident Fund and Employees' State Insurance dues with the appropriate authorities in India.
- xviii. At the last day of the financial year there was no amount outstanding in respect of undisputed income tax, wealth tax, sales tax, customs duty and excise duty which were due for more than six months from the date they became payable.
- xix. During the course of our examination of the books of account carried out in accordance with the generally accepted auditing practices in India, we have not come across any personal expenses which have been charged to Profit and Loss Account nor have we been informed of any such case by the management other than those payable under contractual obligations and accepted business practices.
- xx. The Company is not a sick industrial company within the meaning of clause (o) of Section 3 (1) of the Sick Industrial Companies (Special Provisions) Act, 1985 of India.
- xxi. In respect of services rendered, in our opinion, the Company has a reasonable system, commensurate with its size and the nature of its business, of (a) recording receipts, issues and consumption of materials and stores and allocating materials and stores consumed to the relative jobs, (b) allocating man-hours utilised to the relative jobs. In our opinion, there is a reasonable system of authorisation at proper levels with necessary controls on the issue of stores and allocation of stores and labour to various jobs and the related system of internal control of the Company is commensurate with the size of the Company and the nature of its business.
- xxii. In respect of trading activities there are no goods in the possession of the Company as at 31st March, 2002.

Mumbai,
2nd May, 2002
(Before introduction of CARO '03)

P. Law
Partner
For and on behalf of
PRICE WATERHOUSE
Chartered Accountants

Auditors' report to the members of Infosys Technologies Limited

We have audited the attached Balance Sheet of Infosys Technologies Limited (the Company) as at March 31, 2005, the Profit and Loss Account and Cash Flow Statement of the Company for the year ended on that date, annexed thereto. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As required by the Companies (Auditor's Report) Order, 2003, issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the said Order.

Further to our comments in the Annexure referred to above, we report that :

- (a) we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit;
- (b) in our opinion, proper books of account as required by law have been kept by the Company so far as appears from our examination of those books;
- (c) the Balance Sheet, the Profit and Loss Account and the Cash Flow Statement dealt with by this report are in agreement with the books of account;
- (d) in our opinion, the Balance Sheet, the Profit and Loss Account and the Cash Flow Statement dealt with by this report comply with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;
- (e) on the basis of written representations received from the directors, as on March 31, 2005, and taken on record by the Board of Directors, we report that none of the directors is disqualified as on March 31, 2005 from being appointed as a director in terms of Section 274(1)(g) of the Companies Act, 1956;
- (f) in our opinion and to the best of our information and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India;
- (i) in the case of the Balance Sheet, of the state of affairs of the Company as

- at March 31, 2005;
- (ii) in the case of the Profit and Loss Account, of the profit of the Company for the year ended on that date; and
 - (iii) in the case of the Cash Flow Statement of the cash flows of the Company for the year ended on that date

Bangalore,
April 14, 2005

for BSR & Co.
(formerly Bharat S Raut & Co.)
Chartered Accountants
S. Balasubrahmanyam
Partner
Membership No. 53315

Annexure to the auditors' report

The Annexure referred to in the auditors' report to the members of Infosys Technologies Limited (the Company) for the year ended March 31, 2005. We report that :

1. The Company has maintained proper records showing full particulars, including quantitative details and situation of fixed assets.
The company has a regular programme of physical verification of its fixed assets by which all fixed assets are verified in a phased manner over a period of two years. In our opinion, this periodicity of physical verification is reasonable having regard to the size of the Company and the nature of its assets. No material discrepancies were noticed on such verification.
Fixed assets disposed off during the year were not substantial, and therefore, do not affect the going concern assumption.
2. The Company is a service company, primarily rendering information technology services. Accordingly it does not hold any physical inventories. Thus, paragraph 4(ii) of the Order is not applicable.
3. The company has neither granted nor taken any loans, secured or unsecured, to or from companies, firms or other parties covered in the register maintained under section 301 of the Companies Act, 1956.
4. In our opinion and according to the information and explanations given to us, there is an adequate internal control system commensurate with the size of the Company and the nature of its business with regard to purchase of fixed assets and the sale of services. The activities of the Company do not involve purchase of inventory and the sale of goods. We have not observed any major weakness in the internal control system during the course of the audit.
5. In our opinion, and according to the information and explanations given to us, there are no contracts and arrangements the particulars of which need to be entered into the register maintained under section 301 of the Companies Act, 1956.

6. The Company has not accepted any deposits from the public.
7. In our opinion, the Company has an internal audit system commensurate with the size and nature of its business.
8. The Central Government has not prescribed the maintenance of cost records under section 209(1) (d) of the Companies Act, 1956 for any of the services rendered by the Company.
9. According to the information and explanations given to us and on the basis of our examination of the records of the company, amounts deducted / accrued in the books of account in respect of undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Income-tax, Sales-tax, Wealth tax, Customs duty and other material statutory dues have been regularly deposited during the year by the Company with the appropriate authorities. As explained to us, the Company did not have any dues on account of Employees State Insurance, Excise duty, Service tax and Cess.
According to the information and explanations given to us, no undisputed amounts payable in respect of Provident Fund, Investor Education and Protection Fund, Income tax, Sales tax, Wealth tax, Customs duty and other material statutory dues were in arrears as at March 31, 2005 for a period of more than six months from the date they became payable.
According to the information and explanations given to us, there are no dues of Income tax, Sales tax, Wealth tax and Customs duty which have not been deposited with the appropriate authorities on account of any dispute.
10. The Company does not have any accumulated losses at the end of the financial year and has not incurred cash losses in the financial year and in the immediately preceding financial year.
11. The Company did not have any outstanding dues to any financial institution, banks or debenture holders during the year.
12. The Company has not granted any loans and advances on the basis of security by way of pledge of shares, debentures and other securities.
13. In our opinion and according to the information and explanations given to us, the Company is not a chit fund or a nidhi / mutual benefit fund / society.
14. According to the information and explanations given to us, the Company is not dealing or trading in shares, securities, debentures and other investments.
15. According to the information and explanations given to us, the Company has not given any guarantee for loans taken by others from bank of financial institutions.
16. The Company did not have any term loans outstanding during the year.
17. The Company has not raised any funds on short-term basis.
18. The Company has not made any preferential allotment of shares to companies / firms / parties covered in the register maintained under section 301 of the

Companies Act, 1956.

19. The Company did not have any outstanding debentures during the year.
20. The Company has not raised any money by public issues during the year.
21. According to the information and explanations given to us, no fraud on or by the Company has been noticed or reported during the course of our audit.

for BSR & Co.

(formerly Bharat S Raut & Co.)

Chartered Accountants

S. Balasubrahmanyam

Partner

Membership No. 53315

Bangalore,

April 14, 2005

5.14 Types of opinion / Types of Audit Report

There are four types of opinion that may be made by an auditor which are as follows :

1. Unqualified opinion

Where an auditor gives an opinion on the various matters without any comment or reservations, it is an unqualified opinion. In an independent financial audit unqualified opinion implies that the auditor is of the opinion that the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India.

2. Qualified opinion

When an auditor gives an opinion that financial statements give a true & fair view subject to certain reservations, he is said to have given a qualified opinion. AAS 28 provides that—

A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require adverse opinion or limitation on scope is not so material and pervasive as to require a disclaimer of opinion. A qualified opinion should be expressed as being ‘subject to’ or ‘except for’ the effects of the matter to which the qualification relates.

3. Disclaimer of opinion

Where an auditor fails to obtain sufficient information to warrant an expression of opinion, he makes a disclaimer of opinion. Accordingly the auditor may state that he is unable to express an opinion because he has not been able to obtain sufficient evidence to form an opinion.

As per AAS 28, a disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is accordingly, unable to express an opinion on the financial statements.

(4) Adverse or Negative Opinion

According to AAS-28, an adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Thus, where an auditor concludes that based on his examination he does not agree with the affirmations to be made, he gives an adverse opinion.

Clause 41 of AAS 28 also provides that whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report.

5.15 Independence of auditors

It is fundamental to the whole concept of auditing that the auditor expresses an independent professional opinion on financial statements / accounts. Unless auditors are seen to be independent of the clients on whose accounts they are reporting shareholders and public at large cannot be expected to place faith in their integrity and objectivity.

Guidance note on independence of auditor issued by ICAI is explained below :

Professional integrity and independence is an essential characteristic of all the professions but is more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him, or to his own self-interest. Independence is a condition of mind as well as personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. The code of ethics for Professional Accountants, issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows :-

“Independence is—

(a) Independence of mind—

The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity and exercise objectivity and professional skepticism; and

(b) Independence in appearance—

The avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's integrity, objectivity or professional skepticism had been compromised.

In all phases of a Chartered Accountant's work, he is expected to be independent.

IFAC identifies five types threats to independence. These are :-

1. Self-interest threats

This occurs when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.

2. Self-review threats

This occurs when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.

3. Advocacy threats

Which occurs when the auditor promotes or perceived to promote, a clients opinion to a point whose people may believe that objectivity is getting compromised.

4. Familiarity threats—

These are self-evident and occur when auditors form relationships with the client where they end up being too systematic to the clients interests.

5. Intimidation threats

Which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement or disagreements with the applications of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice. Following are important features of ICAI and Companies Act in respect of ensuring or creating the existence of independence :

(i) As per ICAI guidelines chartered accountants are advised to apply a specific guiding principles. (like independent of the entities that they are auditing etc.)

(ii) As per Companies Act requirements :

* Disqualifications under section 226

* Passing of resolution in general meeting for appointment as per Section 314 of the Companies Act.

(iii) As per code of ethics under the CA Act, 1949 clause 10 of Part I of the First Schedule to the CA Act, 1949 prohibits acceptance of, what have been described as contingent fees i.e. fees which are either based on percentage of profits or otherwise dependent on the finding or the result of employment.

(iv) Clause (H) of part I of second schedule to the CA. Act, 1949 provides that a practising Chartered Accountant shall be deemed to be guilty of professional misconduct if he expresses his opinion on financial statements of any business or any enterprise in which he, his firm or partner in his firm has a substantial interest, unless he disclose his interest also in his report.

(v) A member must take care to see that he does not get into situations where there could be conflict of interest and duty.

(vi) A CA in employment should not certify the financial statements of the concern in which he is employed.

(vii) The council of the institute wishes to emphasise that clause (4) of part I of second schedule to the CA Act, 1949 should be equally applicable to all types of audit function by the members (the special auditor, audit etc.)

(viii) The members are not permitted to write the books of accounts of their auditee clients.

(ix) A statutory auditor of a company cannot also be its internal auditor as it will not be possible for him to give independent and objective report with respect to CARO '03 under section 227 (4A) of the Companies Act.

(x) Apart from these, to ensure that the professional independence of a member doing attest function does not appear to be jeopardized he should as far as possible, take care to see the compliance of restrictions in respect of earnings of professional fees and rules regarding professional misconduct as per clause (8) and (9) of Part I of First schedule to the CA Act, 1949.

If the opinion of chartered accountant is to command respect and the confidence of the public, it is essential that they must ensure their independence to assure the public as regards faith and confidence that could be reposed on him, where he feels that independence is jeopardized he should refrain from accepting the appointment.

5.16 The True and Fair View

The expression “true and fair view” is central to auditing and yet it is an abstraction whose meaning is far from clear. It is an abstract idea of immense importance and difficulty.

The Companies Act states that every balance Sheet should give a true and fair view of the statement of affairs of the company at the end of financial year and every profit and loss account give a true and fair view of profit and loss of the company for the financial year [Sec. 211 (1) & Sec. 211 (2)]. The financial year implies accounting year of the company. Again subsection (5) of sec 211 implies that balance sheet and profit and loss of a company shall be deemed as not showing a true and fair view, if they do not disclose any matters which are required to be disclosed by the virtue of the provisions of schedule VI, any notification, any order of the central government. It is important to mention here that disclosure requirement as per Companies Act is the minimum requirements and if it is seen certain information is vital for showing a true and fair view. The financial statement must disclose it although no specific requirements were there thus as per the company law “truth and fairness” is a fundamental qualitative characteristics of financial statements.

The idea of truth and fairness involves a number of thoughts including

- * Expectation
- * Relevance
- * Objectivity
- * Freedom from bias
- * Beyond simple conformity
- * Compliance with GAAP
- * Disclosure
- * Understandability
- * Reliability
- * Comparability
- * Materiality

The Directors Responsibility Statement is a step to ensure “truth and fairness” in the financial statements.

As per AAS 28, auditor’s report must include an opinion as to whether the financial statements give a true and fair view in accordance with the financial reporting framework.

The Phrase ‘true and fair view’ in the auditor’s report, thus signifies that the auditor makes an opinion as to whether the financial statements represent fairly the actual financial position at the end of the accounting period and profit and loss of that period. So, what constitute a true and fair view is a matter of an auditor’s judgement in the particular circumstances of the case. However, the following guidelines may be used to judge the true and fair view :-

1. The balance sheet and profit and loss account must be drawn up in conformity with the requirements of the Companies Act, or other relevant Acts.
2. Relevant information must be disclosed and Balance Sheet and profit and loss account should state the actual position i.e. no over or under statement and no window dressing in balance sheet and profit and loss account. There should not be creation of any secret reserve unless statements specifically permits that.
3. All material facts should be disclosed in respect of expenses, income, assets and liabilities and also there should not be any misstatement. Least-as good ideas to be avoided.
4. All unusual, exceptional or non-recurring items should be disclosed separately.
5. Balance Sheet and profit and loss account should be prepared and presented in conformity with the GAAP and that is to be followed consistently and in case of any departure fact alongwith the effect to be disclosed.
6. Post balance sheet events should be considered properly if the auditor thinks it necessary to do so.
7. The financial statements must convey the required information clearly to facilitate the quality of understandability and full disclosure. It is important to mention that it has been decided in many legal cases that information and means of information are by no means equivalent terms.

5.17 Concept of Materiality

The concept of materiality is state of relative importance which varies from person

to person. It is fundamental to the process of recognition, aggregation, classification and presentation of financial information which encompasses financial statements. It is an important consideration for the auditor who constantly has to judge whether a particular item or transaction is material or not.

The generation of materiality arises in many stages in the course of an audit. The auditor has to apply the concept of materiality in the following situations :

- a) while determining the nature, timing and extent of audit procedure;
- b) while evaluating the effect of misstatements.
- c) when mistakes are disclosed by the auditors in the accounting books and records i.e., calculation of depreciation, information of stock etc.
- d) In disclosing the non-recurring and unusual items of income or expenditures.
- e) In respect of treatment and disclosure of prior period items
- f) Disclosure of items required as per law, statutes etc.

The related provisions in respect of materiality may be mentioned as follows :-

1. Part II of schedule VI to the Companies Act, 1956 requires that every profit and loss account should disclose every material information affecting the working results to facilitate the objective of exhibiting true and fair view of state of affairs and working results of the company.

2. AS 1, 'Disclosure of Accounting Policies', defines material items as the items knowledge of which might influence the decisions of the user of the financial statements.

3. AAS 6, 'Risk Assessments and Internal Control' also takes into consideration relationship between concepts of materiality audit risk, and internal control.

AAS 13, 'Audit Materiality' state that information is material if its misstatement could influence the economic decisions of the users taken on the basis of the financial information. Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement.

4. Clauses 5, 6, 8 and 9 of Part I of the second schedule to the Chartered Accountants Act, 1949, refer to material fact, material misstatement, material exceptions and material departure from GAAP.

5.18 Divisible Profits and Dividend

5.18.1 Divisible Profit

The amount which can be distributed legally as dividend to the shareholders is called divisible profit. The following four considerations may govern the determination of amount of divisible profit :

1. Principle of accounting
2. Provisions of Memorandum and Article of Association
3. Provisions of the Companies Act (Section 205)

4. Legal decisions (Lee Vs. Neutchatel Asphalt Co. Ltd., Wilmer V. McNamara & Co. Ltd.)

5.18.2 Auditor's Duty regarding divisible profit

The auditor should take into consideration the following points while verifying the divisible profit of a company :

- (1) Verification of amount of profit
- (2) Verification of the provisions of the Companies Act regarding depreciation as mentioned in Section 205.
- (3) Verification of the provision of income-tax.
- (4) Examination of transfer to reserve (according to Companies Act and Article of Association)
- (5) Verification of transfer of profit to Debenture Redemption Fund, if required.
- (6) Treatment of writing off past losses.
- (7) Consideration towards inclusion of information in audit report in respect of any contravention of all these formalities

5.18.3 Dividend

The portion of the divisible profit which is actually distributed to the shareholders is called dividend.

● Classification of Dividend

Dividend can be classified in the following ways :

- (i) On the basis of source,
 - a. Retained Earnings
 - b. Current profit
- (2) On the basis of medium of payments :
 - a. Cash dividend
 - b. Share dividend.
- (3) On the basis of regularity of Payment :
 - a. Interim dividend
 - b. Annual (Final) dividends.

● Payment of Dividend

Dividend may be paid–

- (i) Out of the current year's profit
- (ii) Out of the profit of the past year
- (iii) Out of both
- (iv) Out of moneys provided by the Central Government or state government for the

payment of dividend in accordance with any guarantee given.

● **Interim Dividend**

Dividend which is declared in between two AGM is called interim dividend. Article of association of a company must give power to Board of Directors to give such dividend and for which no general meeting is necessary.

● **Final Dividend**

After completion and preparation of financial statements Board of Directors of a company, following the Articles of Association, declares the final dividend and must be passed in the general meeting.

● **Factors for declaration and payment of Dividend**

Following factors to be considered by a company for declaration and payment of dividend.

A. Accounting aspects :

- i) Depreciation (Sec 205)
- ii) Past losses [Sec 205 (i)(b)]
- iii) Provision for certain liabilities and tax.
- iv) Transfer to reserve [Section 205 (2A)]
- v) Contractual obligation (in case of loan)
- vi) Dividend out of capital profits.
- vii) Income Tax
- viii) Dividend Tax if any.

B. Provisions of Companies Act

(i) Section 205 states the dividend can be paid only out of current or past profits or money received from any government for this purpose.

(ii) If there is unpaid capital, proportionate dividend should be paid on paid up capital (Sec-193).

(iii) Dividend always should be paid in cash except bonus shares [Sec 205 (3)].

iv) Dividend is to be paid either in cheque or by issuing dividend warrant [Sec 205 (5)(B)]

v) Dividend in cheque should be sent to the registered shareholders or to his order or to his bankers. (Section 205C)

vi) Dividend to be paid or warrant to be sent within 30 days from the date of declaration of dividend and if not, officer responsible, for this will be punishable by fine and imprisonment exceeding 3 years excepting in the following cases :

- a) Legal barrier
- b) Impossible to do shareholders' instruction
- c) Disputed case
- d) Non-fault on the part of the company. (Sec 207)

vii) Unpaid dividend to be transferred to special dividend account within 7 days from the date of expiry of 30 days from the date of declaration of dividend if it is not paid by the company or claimed by the shareholders. (Sec 205A)

viii) Table A of Schedule I (Standard clause in Articles of Association)

Clause 85 : Rate of dividend in GM should never exceed the rate declared by BOD.

Clause 86 : Interim dividend may be paid in the BOD may think such payment to be reasonable.

Clause 87 : If reasonable the BOD may not paid dividend.

Clause 88 : No dividend will be paid on advance money receivable from shareholders.

Clause 92 : In case of joint shareholding either of the parties may receive dividend by showing the receipt.

Clause 93 : Notice of dividend must be sent to the shareholders who are entitled to receive dividend.

Clause 94 : No interest can be paid on dividend.

Apart from these formalities an auditor should also look into the matter relating to compliance of FEMA Act, RBI Rules and Income-tax Act in respect of declaration and payment of dividend paid to shareholders residing outside India.

● Dividend and auditor's duty

Following factors should be considered by an auditor in respect of audit of dividend :

i) Examination of Articles of Association.

ii) Verification of sources of dividend.

iii) Review of Minute Book

iv) Verification of dividend register.

v) Examination of bank account in respect payment of dividend.

vi) Examination of payment of dividend with respect to its time limitation.

vii) Verification of unclaimed dividend account to ensure proper transfer as per section 205A of the Companies Act.

viii) Examination of compliance of section 205A regarding transfer of profit to reserve [Rule 3 of Companies (Transfer of Profits to Reserve) Rules, 1975.]

ix) Examination of transfer of unclaimed amount in unclaimed dividend account to the General Reserve of the Central Government.

x) Verification of compliance of the rules contained in Table A.

xi) Verification of compliance of Companies Act, RBI Rules, FEMA Act, and Income tax requirements to the extent they are related to the declaration and payment of dividend.

5.19 Others

Also the payment of dividend out of capital profits, payment of interest out of capital (Sec. 208) are the important areas to be taken up by the students which requires knowledge of relevant provisions of the companies Act, ICAI guidelines, decisions held in many important legal cases and above all the business and accounting prudence.

5.20 Questions

1. State the provisions of Companies Act 1956 regarding qualification, disqualification of an auditor.
2. How is an auditor of a company appointed? State the provisions as to their removal and remunerations.
3. Explain the rights and duties of an auditor of a company.
4. Describe the contents of audit report.
5. What are specific matters to be considered by an auditor as per CARO '2003 under Companies Act.
6. State the factors to be considered for declaration and payment of dividend.
7. Write short notes :
 - a) Branch Audit b) Audit Ceiling c) True & Fair view d) Independence of Auditor
 - e) Concept of materiality f) Unclaimed dividend g) Interest paid out of capital h) Dividend paid out of capital profits.