Technical Guide on Audit in Automobile Industry

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

New Delhi

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FOREWORD

The Automobile industry in India is the ninth largest in the world and is currently growing at a pace of around 18% per annum. Due to low cost of labour, India has become a hot destination for a number of global auto players. According to reports, car sales in January, 2011 witnessed a growth of 32% which is the highest ever witnessed by the auto industry and has come on the back of economic growth, reduced interest rates and better money supply in the system.

Audit of such a rapidly growing industry involves many audit peculiarities which can be addressed through an Industry specific audit guide. Hence, it is heartening to note that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has come out with a Technical Guide on Audit in Automobile Industry, which has been authored by senior members of the profession. I am also glad to note that the guide formulated in an easy to understand language contains detailed and in depth guidance on the various intricacies involved in audit of automobile companies.

I wish to place my appreciation to CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board in his vigorous efforts of spreading awareness regarding Standards on Auditing and helping the members with such useful industry specific guides.

I am extremely confident that this Technical Guide would help the members and other readers understand the auditing aspects of the automobile industry.

New Delhi
June 21, 2011

CA. G. Ramaswamy
President, ICAI

PREFACE

One of the major industrial sectors in India is the automobile sector. India manufactures over 11 million vehicles and exports about 1.5 million every year. Subsequent to liberalisation, the automobile sector has been aptly described as the sunrise sector of the Indian economy as this sector has witnessed tremendous growth. The Indian automobile industry is currently going through a phase of rapid change and high growth. A number of our members are engaged in various capacities in the automobile sector. As statutory auditors, our members have played an important role in ensuring the credibility of the financial information being sent out to the various stakeholders in the financial reporting process.

Every industry has certain peculiarities, industry practices, customs and usages which, in addition to the Accounting Standards define and shape its internal controls, including its financial reporting processes and ultimately, the preparation and presentation of its financial statements. Adequate knowledge of the client and the peculiarities, practices, etc., of the industry in which it operates is therefore an indispensable for an auditor to properly plan and execute an audit that also meets quality standards and provides a value add to the client. With this perspective in mind, the Auditing and Assurance Standards Board brings out industry specific audit guides. This Technical Guide on Audit in Automobile Industry is one such Guide in the series.

This Technical Guide on Audit in Automobile Industry comprehensively covers its important aspects, growth and background, the regulatory environment, main revenue streams, special considerations relating to fixed assets and inventories, peculiarities associated with other assets, loans and advances, current liabilities and provisions, including product warranties in automobile industry and the related audit procedures for each of the aforementioned items of financial statements. The Guide has been authored by eminent experts in the field of audit in the automobile industry.

I am extremely grateful to CA. N. Venkatram, Mumbai and CA. Munish Saraogi, New Delhi, for squeezing time out of their demanding professional and personal preoccupations, to author this Guide. I am also thankful to CA. K. Sairam and CA. Shernaz Dadachandji, Mumbai for their contributions to giving final shape to this Guide.

At this juncture, I wish to express my sincere thanks to CA. G Ramaswamy, President, ICAI as well as CA. Jaydeep N. Shah, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

Many thanks are also due to my Council colleagues at the Board, *viz.,* CA. Rajkumar S Adukia, Vice Chairman, CA. Amarjit Chopra, CA. Naveen N.D. Gupta, CA. Sanjeev K. Maheshwari, CA. M. Devaraja Reddy, CA. Rajendra Kumar P., CA. J. Venkateswarlu, CA. Sumantra Guha, CA. Anuj Goyal, CA. Pankaj Tyagee, CA. Jayant P. Gokhale, CA. S. Santhanakrishnan, CA. Mahesh P. Sarda, CA. Vijay Kumar Garg, CA. V. Murali, CA. Nilesh S. Vikamsey and the Central Government nominees, Shri Prithvi Haldea and Smt. Usha Shankar and also to the co-opted members at the Board, *viz.*, CA. David Jones, CA. Sanjay Vasudeva, CA. Raviprasad, CA. P.R. Vittel, CA. C.N. Srinivasan, CA. Ramana Kumar B., for their dedication and support to the workplan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, *viz*., Mr. Vinod Chandiok, Prof. A. Kanagaraj, CA. Amit Roy, Shri Sunil Kadam, CA. Raj Agrawal, CA. Bhavani Balasubramanian, CA. K. Rajasekhar, CA. Harinderjit Singh, Mrs. B. Padmaja for their support to the Board.

I am confident that this Technical Guide will help auditors perform high quality and efficient audits in the automobile industry.

Kolkata
June 10, 2011

CA. Abhijit Bandyopadhyay
Chairman,
Auditing & Assurance Standards Board

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Chapter 1
Introduction

Industry Overview

1.1 The Indian automotive industry after de-licensing in July, 1991 has demonstrated sustained growth as a result of increased competitiveness and relaxed restrictions. From 2003-04 to 2009-2010, passenger vehicle sales in India have grown at a CAGR of 13.7%; this growth is unlikely to stop in the coming decade. The total vehicle sales in that period grew by 10.3%. *(Source: Siam November 2010)*

1.2 There are two distinct sets of players in the Indian auto industry: automobile component manufacturers and the vehicle manufacturers, which are also referred to as Original Equipment Manufacturers (OEMs). While the former is engaged in manufacturing parts, components, bodies and chassis involved in automobile manufacturing, the latter is engaged in assembling of all these components into an automobile.

1.3 The Indian automotive component manufacturing sector consists of 500 firms in the organised sector and around 31,000 enterprises in the unorganised sector. In the domestic market, the firms in this sector supply components to vehicle manufacturers, other component suppliers, state transport undertakings, defence establishments, railways and even replacement market. A variety of components are exported to OEMs abroad and after-markets worldwide.

1.4 The automobile manufacturing sector, which involves assembling the automobile components, comprises two-wheelers, three-wheelers, four-wheelers, passenger cars, light commercial vehicles (LCVs), heavy trucks and buses/coaches. In India, mopeds, scooters and motorcycles constitute the two-wheeler

industry. In 2009-10, the Indian auto sector had produced over 10.5 million two wheelers and 1.9 million passenger cars. *(Source: CIER Industry Statistic)*

1.5 India is a global major in the two-wheeler industry producing motorcycles, scooters and mopeds principally of engine capacities below 200 cc. It is the second largest producer of two-wheelers in the world. The two-wheeler industry in India has grown at a compounded annual growth rate of more than 10 per cent (in number) during the last five years and has also witnessed a shift in the demand mix, with sales of motorcycles showing an increasing trend. Indian two wheelers comply with some of the most stringent emission and fuel efficiency standards worldwide.

1.6 The automotive industry is a volume driven industry and certain critical mass is a pre-requisite for attracting the much needed investment in Research and Development (R&D) and New Product Design and Development. R&D investment is needed for innovations which is the life-line for achieving and retaining the competitiveness in the industry. This competitiveness in turn depends on the capacity and the speed of the industry to innovate and upgrade. The most important indices of competitiveness are productivity of both labour and capital.

1.7 The automotive sector with its deep backward linkages (such as metals like steel, aluminium, copper etc., plastic, paint, glass, electronics, capital equipment, trucking, warehousing and logistics) and forward linkages (including dealership retails, credit and financing, logistics, advertising, repair and maintenance, petroleum products, gas stations, insurance, service parts) has been recognized and identified at different forums (Development Council of Automobile and Allied Industries, Planning Commission, National Manufacturing Competitiveness Council and Investment Commission etc.) as a sector with a very high potential to increase the share of manufacturing in GDP, exports and employment. The sector is also seen as a multiplier of industrial growth.

1.8 India with its rapidly growing middle class with an increasing purchasing power, market oriented stable economy, availability of trained manpower at competitive cost, fairly well developed credit and financing facilities and local availability of almost all the raw materials at a competitive cost has emerged as one of the favourite investment destinations for automotive manufacturers. The rapid improvement in infrastructure including road, port, power and world class facilities for testing, certification and homologation, coupled with enabling government policies to promote fair competition make Indian automotive industry more competitive in world. These advantages need to be leveraged in a manner to attain the twin objectives of ensuring availability of best quality product at lowest cost to the consumers on one hand and developing and assimilating the latest technology in the industry on the other. The Government recognizes its role as a catalyst and facilitator to encourage companies to move to higher level of competitive performance. The Government wants to create a policy environment which will encourage growth, promote domestic competition, stimulate innovation and help companies gain competitive advantage.

1.9 The auto industry has grown in clusters of interconnected companies which are linked by commonalities and complementarities. The major clusters are in and around Manesar in the North, Pune in the West, Chennai in the South, Jamshedpur-Kolkata in the East and Indore in Central India. The Department of Heavy Industries is envisaging in the Eleventh Five-Year Plan period to create a National Level Specialized Education and Training Institute for the automotive sector and to enhance the transportation, communication and export infrastructure facilities through concerned Ministries in and around these clusters.

1.10 The industry being highly capital intensive, has entry barriers for smaller players. Even the existing global auto majors are realigning their production bases - coming closer to the scene

of action in Asia-Pacific region, mainly in China, India and Thailand. Besides the above, the constant pressure for cost reduction on original equipment manufacturers (OEMs) is compelling them to outsource more and more components from low cost countries. The changing scenario has opened up opportunities for the Indian automotive industry.

Evolution and Policy Framework Surrounding the Indian Automotive Sector

1.11 While the genesis of the Indian automotive industry can be traced to the 1940s, distinct growth decades started in the 1970s. Between 1970 and 1984 cars were considered a luxury product; manufacturing was licensed, expansion was restricted; there were quantitative restrictions on imports and a tariff structure designed to restrict the market. The market was dominated by six manufacturers - Telco (now Tata Motors), Ashok Leyland, Mahindra & Mahindra, Hindustan Motors, Premier Automobiles and Bajaj Auto.

1.12 The decade of 1985 to 1995 saw the entry of Maruti Udyog in the passenger car segment and Japanese manufacturers in the two wheelers and light commercial vehicle segments. Economic liberalization, which started in 1991, led to the delicensing of the passenger car segment in 1993 though quantitative restrictions on imports continued. This decade witnessed the emergence of Hero Honda as a major player in the two wheeler segment and Maruti Udyog as the market leader in the passenger car segment.

1.13 Between 1995 and 2000 several international players entered the market. Advanced technology was introduced to meet competitive pressures and adhere to environmental and safety norms. Automobile companies started investing in service networks to support maintenance of on-road vehicles. Auto financing started emerging as an important driver for demand.

1.14 Starting in 2000, several landmark policy changes like removal of quantitative restrictions and 100 percent foreign direct investment (FDI) through automatic route were introduced. The

import of technology for technology upgradation on royalty payment of 5% without any duration limit and lump sum payment of USD 2 million is also now allowed under automatic route in this sector. These changes have led to dramatically increased competition from imported vehicles, including second hand or pre-owned vehicles. Indigenously developed (Made in India) vehicles were introduced in the domestic market and exports were given a thrust. Auto companies started collaboration with financial firms to provide auto financing and insurance services to customers. Manufacturers also introduced systems to improve capacity utilization and adopted quality and environmental management systems. In 2003, the Core-group on Automotive R&D (CAR) was set up to identify priority areas for automotive R&D in India.

1.15 Though there remain relatively high tariffs on imports of vehicles and components, the tariffs on the import of components and cars in completely built units (CBUs), and/or completely knocked down units (CKDs), are expected to be reduced in the future in line with India's obligations under the World Trade Organization agreement.

1.16 The automotive industry in India is now working in terms of the dynamics of an open market. Many joint ventures have been set up in India with foreign collaboration, both technical and financial with leading global manufacturers. Also a very large number of joint ventures have been set up in the auto-components sector and the pace is expected to pick up even further. The Government of India is keen to provide a suitable economic and business environment conducive to the success of the established and prospective foreign partnership ventures.

Constituents of the Automotive Industry

1.17 The automotive industry is a highly diversified sector that comprises of manufacturers, suppliers, dealers, retailers, original equipment manufacturers or OEMs, aftermarket parts manufacturers, automotive engineers, motor mechanics, auto electricians, spray painters or body repairers, fuel producers, environmental and transport safety groups, and trade unions.

1.18 The automobile and automotive parts and components manufacturers constitute a major chunk of automotive industry not only in India but throughout the world The automotive component industry manufactures a wide range of parts including castings, forgings, finished, semi-finished components, assemblies, and subassemblies for all types of vehicles produced in India.

1.19 While the OEMs are at the top of the auto supply chain, it should be noted that there are a few OEMs in India which supply some components to other OEMs in India or abroad. Most of the Indian OEMs are members of the Society of Indian Automobile Manufacturers (SIAM), while most of the Tier-1 auto component manufacturers are members of the Automobile Component Manufacturers' Association (ACMA). All of them are in the organised sector and supply directly to the OEMs in India and abroad or to Tier-1 players abroad.

1.20 Tier-2 and Tier-3 auto-component manufacturers are relatively smaller players. Though some of the Tier-2 players are in the organised sector, most of them are in the unorganised sector. Tier-3 manufacturers include all auto-component suppliers in the unorganised sector, including some Own Account Manufacturing Enterprises (OAMEs) that operate with one working owner and his family members, wherein manufacturing involves use of a single machine such as the lathe.

1.21 Auto-component manufacturers cater not only to the OEMs, but also to the after-sales market. In the recent years, there has been a rapid transformation in the character of the automotive aftermarket, as a fast maturing organised, skill-intensive and knowledge driven activity. Hence, the auto industry in India possesses a very diverse and complex structure, in terms of scale, nature of operation, market structure, etc. While output, emoluments and Gross Value-Added (GVA) have been growing in both the automobile and auto-component industries, employment is on the rise in the latter and it is declining in the former.

1.22 The unorganised sector consists of enterprises that are not registered under certain sections of the Factories Act. The unorganised auto sector in India has grown in terms of number of

enterprises, employment, output, capital, capital intensity and labour productivity. However, capital productivity has fallen considerably in this sector.

Evolution of the Auto Component Sector in India

1.23 In 1953, the Tariff Commission in its report to the Government had stressed the need for a balanced and integrated development of the automotive industry by promoting the emergence of a strong auto-component sector. As a result of this recommendation, the leading entrepreneurs were invited by the Government to establish an auto- component manufacturing industry.

1.24 In the pre-1985 era, the auto component sector was a protected market with high import tariffs. The market was oriented primarily towards supply of components to domestic manufacturers.

1.25 In the 1980s, encouraged by the establishment of many Japanese OEMs in the passenger car, two-wheeler and LCV industry in the country, a number of Indian companies entered into joint ventures with Japanese companies and exports also commenced.

1.26 The Phased Manufacturing Programme (PMP) introduced in the Indian automotive sector in the 1980s for localization had laid the foundation for the development of the auto component industry. This programme enabled the auto-component industry to modernize its technology, improve quality and to imbibe good manufacturing and shop-floor practices and to transform itself into a highly capable sector of the industry, while at the same time contribute to localizing the component base. In 1990s global OEMs and Tier 1 suppliers started operations in India. This paved the way for a large number of new joint ventures in the component industry with European and American component manufacturers and gave the Indian component industry an all-round expertise to manufacture components for Japanese, European as well as American vehicles. After the PMP programme came to an end in 1991, the Government introduced the Memorandum of

Understanding (MOU) system that continued to place emphasis on the aspect of localization of components. With support from this policy, the component industry developed further capability to manufacture the new breed of auto-components required for the new generation vehicles.

1.27 The Indian automobile ancillary sector has thus transformed itself from a low-volume, highly fragmented one into a competitive industry, backed by competitive strengths, technology and transition up the value chain. Today, the auto component industry is one of the fastest growing segments of Indian manufacturing due to its capability to manufacture the entire range of auto parts and rapidly increase its capacity base. As stated above, the Indian automotive component industry can be divided into the organized and the unorganized segments. While the forte of the organized sector is the high valued added precision engineering products, the presence of a large unorganized sector is characteristic especially of the lower value-added segments of the industry.

1.28 The ACMA-McKinsey Vision 2015 document forecasts the potential for the Indian auto component industry to be US$ 40-45 billion by 2015. Today vehicle manufacturers outsource more and more components rather than manufacturing them in-house. Investments and exports in this segment are witnessing continuous growth. Global automobile manufactures see India as a manufacturing hub for auto components and are rapidly ramping up the value of components they source from India due to:

- the cost competitiveness in terms of labour and raw material.
- its established manufacturing base.
- fine quality of components manufactured in India.

Whenever required, OEMs supported component manufacturers through equity participation, technical collaboration, etc.

The U.S. and European markets account for 28% each of the total exports from the Indian auto component companies. More than 70% of the exports go to the OEMs and Tier I suppliers and only

30% to the global aftermarket, indicating the high level of maturity in quality and technology that has been achieved by the component industry.

1.29 On the quality and productivity front, the auto component industry maintained its leadership with more than 95% companies being certified as per the ISO 9000 system standards and more than 70% of the companies certified as per the ISO/TS 16949 standards. It has also the distinction of having the maximum number of 11 Deming award winning companies.

Capacity Utilisation

1.30 Most automobile assemblers in India produce less than their installed capacity. This is because of various reasons. First, capacity utilisation is totally demand dependent. Secondly, some of these firms intentionally keep their installed capacity higher than what is required to let it serve as a buffer capacity to cater for growth and demand uncertainty. Thirdly, the production is flexible and gets adjusted based on market forecasts. Firms that have faced bottlenecks in production capacity have increased their capacities either by increasing number of production shifts or by establishing new plants.

1.31 However, the situation is different and diverse for the auto-component firms. In about 60 per cent of the auto-component firms, actual production is higher than installed capacity. In general, this problem is tackled by going for sub-contracting and outsourcing. Some firms are capable of increasing their capacities, with the lag time of less than six months. A few other firms have started establishing new capacities, while others have joined hands with foreign firms for higher and better capacities, mainly through acquisitions.

1.32 Around 20 per cent report underutilisation of their existing installed capacities due to varied reasons: lack of demand, machinery maintenance schedules, technical defects in machineries and demand uncertainty. Of these, lack of demand

appears to reflect the fact that these firms are not competitive enough to derive advantages from growing automobile market.

Growth Drivers in the Automotive Industry

1.33 Rising per capita income and the changing demographic distribution are conducive for growth. India has the highest proportion of population below 35 years, 70%, (potential buyers), which means that 130 million people were added to the working population between 2003 and 2009. The trends indicate that small and medium cars would remain dominant and a shift towards high end cars is expected at a faster rate. The Sports Utility Vehicles (SUV) market is expected to develop rapidly in future. Higher disposable incomes coupled with availability of easy finance options have driven the passenger vehicle segment.

1.34 In the commercial vehicle segment, increased investment in road infrastructure and availability of cheaper finance has led to a growth in multi-axle vehicles. This is expected to be followed by a shift to tractor-trailer combinations on account of operating economics of higher power-to-weight ratio vehicles. Growth in the demand for pick-up trucks has coincided with the growth in multi-axle vehicles. The next growth driver for LCVs is expected to be the introduction of lighter pick-ups.

1.35 The two wheeler segment growth is led by rapid urbanization and resultant rise in demand from semi-urban and rural areas, increasing income levels, wider product range available to customers, and easy finance options.

1.36 The growth in tractor industry is linked with the growth in agricultural output and exports to neighbouring countries.

1.37 Auto component industry growth is directly linked to the growth of automobile industry since more than 65% sales is to the OEMs. However, in recent years, component exports are becoming an important growth driver and it is expected to assume greater importance in future.

1.38 The following are the key growth drivers for the automobile industry:

- Rising industrial and agricultural output.
- Rising per capita income.
- Favourable demographic distribution with rising working population and middle class Urbanisation.
- Increasing disposable incomes in rural agri-sector.
- Availability of a variety of vehicle models meeting diverse needs and preferences.
- Greater affordability of vehicles.
- Easy finance schemes.
- Favourable government policies.
- Robust production.

Export Trends

1.39 Compared to domestic sales, vehicle exports have grown at the rate of 39% CAGR over the last five years, led by exports of passenger cars at 57% and two wheeler exports at 35%. Last year however, overall exports registered a growth of around 28%. In value terms, exports crossed USD 2 billion. The key destinations are the SAARC countries, European Union (Germany, UK, Belgium, the Netherlands and Italy), Middle East and North America. Maruti Udyog, Tata Motors and Hyundai Motor India are key exporters for passenger cars; Mahindra & Mahindra and Tata Motors for light commercial vehicles, medium and heavy commercial vehicles, Mahindra & Mahindra for Multi Utility Vehicles (MUVs), Bajaj Auto for two and three wheelers and Mahindra & Mahindra and TAFE for tractors. A 3% growth in global demand is anticipated over the next five years and it will be led by Asia (mainly by China, India and ASEAN). Also global auto companies are increasingly sourcing components and vehicles

from low cost countries. The outsourcing pie is slowly extending to services like engineering design and other business processes. India is well positioned to take advantage of the outsourcing opportunities.

Recent Policy Initiatives

National Automotive Testing and R&D Infrastructure Project (NATRIP)

1.40 To put the Indian automotive industry on the global map, the National Automotive Testing and R&D Infrastructure Project (NATRIP) at the total cost of Rs. 1,718 crores has been initiated.

This project principally aims to:

- create critically needed automotive testing infrastructure to enable the government in ushering in global vehicular safety, emission and performance standard,
- deepen manufacturing in India, promote larger value addition and performance standards and facilitates convergence of India's strength and IT and electronics with automotive engineering,
- enhance India's abysmally low global outreach in this sector by debottlenecking exports, and
- provide basic product testing, validation and development infrastructure so that Indian automotive sector would not face any export obstacle in the foreign market.

The Automotive Mission Plan (2006-2016)

1.41 In order to develop and realize the growth potential of the automotive sector both at domestic and global level, and to optimize its contribution to the national economy, the Department of Heavy Industries drew up a 10 year Mission Plan for the development of Indian automotive sector and creation of global hub.

1.42 The Automotive Mission Plan (AMP) 2006-2016, aims at doubling the contribution of automotive sector in GDP by taking the turnover to USD 145 billion and providing additional employment to 25 million people by 2016 with special emphasis on export of small cars, MUVs, two and three wheelers and auto components.

1.43 Implementing AMP 2006-2016 would need an incremental investment in the order of USD 35-40 billion in the Indian auto industry from 2006 to 2016. It is anticipated that the bulk of this investment will come from expansion of capacities by existing manufacturers operating in India and remaining from global multinational corporations (MNCs) seeking to make India their manufacturing base. Competition for attracting investments in India would come from countries such as China and Thailand.

1.44 The future challenges for the Indian automobile industry in achieving the targets defined in the Automotive Mission Plan would primarily consist of developing a supply base in terms of technical and human capabilities, achieving economies of scale and lowering manufacturing costs, overcoming infrastructural bottlenecks, while at the same time stimulating domestic demand and exploiting export and international business opportunities.

1.45 Interventions envisaged for the successful implementation of this Plan are required at two levels - Industry and the Government. The Government would play a key enabling role in facilitating infrastructure creation, promote the country's capabilities, create a favourable and predictable business environment, attract investments and promote R&D.

1.46 The role of Industry will primarily be in designing and manufacturing products of world-class quality standards, establishing cost competitiveness, improving productivity of both labour and capital, achieving scale and R & D enhancing capabilities and showcasing India's products in potential markets.

Competitiveness in Manufacturing

1.47 The share of the manufacturing sector (within the Industry sector) has shown only a marginal improvement in the last decade. It is known that stagnation of manufacturing as a proportion of GDP has adverse impact on employment generation. Therefore it is imperative to boost manufacturing given the huge anticipated increase in the workforce over the next 15 years.

1.48 As observed by the National Manufacturing Competitiveness Council in its national manufacturing strategy, the challenges faced by Indian manufacturers raise important questions for both Industry and Government "…. this calls for 'breakthrough' and bold thinking on the part of all stakeholders. Only bold aspirations can enable India benefit from emerging opportunities in the manufacturing sector''.

1.49 The productivity in the automotive industry in India is substantially higher than other sectors and it has a huge potential for further improvement, which in turn will pull up the competitiveness of entire manufacturing sector. Hence, it becomes imperative to identify factors that make manufacturing in India un-competitive and address these and improve our competitiveness.

1.50 The National Manufacturing Competitiveness Commission's National Manufacturing Strategy lists the following factors impacting manufacturing competitiveness:

(i) Higher import duties including inverted duty structure on raw materials.

(ii) Higher incidence of indirect taxes.

(iii) Sub-optimal levels of operations.

(iv) Lower operational efficiencies and higher transaction costs.

(v) Lower labour productivity and higher cost of capital.

(vi) Inadequate infrastructure.

1.51 In a survey of corporates, the following factors were ranked on the basis of the responses:

(i) Flexibility in labour laws.

(ii) Scale of operations.

(iii) Cost of capital.

(iv) Cost, availability and quality of raw materials.

(v) Technology gap with international levels.

(vi) Power costs.

(vii) Cost of compliance to government regulations.

(viii) Quality of transport infrastructure.

1.52 The key factors that contribute to competitiveness of a country or a location can be summarized as shown in the table below.

Efficiency factor	Labour Productivity cost Labour Flexibility Capital efficiency / other production factors
Resource Availability	Quality Manpower Infrastructure Raw Materials
Ability to attract investment	Economic Policies and Stability Incentives
Proximity to Markets	Domestic / Exports Auto clusters

1.53 In a study commissioned by SIAM, ICRA Advisory Services evaluated the Indian and Chinese economies from an automotive manufacturing perspective. A cost comparison study between Indian and Chinese automotive manufacturing companies reveals that the cost of manufacture of a passenger vehicle in China is 23% lower than in India with the principal difference owing to higher taxes and their cascading impact in India. Higher labour productivity and lower infrastructural costs

make China more competitive. The study also revealed that since design and engineering capabilities in India have not been as strong there would be a disadvantage of 30% higher costs for products manufactured in India. While some of the above issues like scale of operations and labour productivity are industry or company related, others are identified for improvement and strengthening by the Government.

Prescriptions for Industry in the National Manufacturing Strategy

1.54 The National Manufacturing Strategy has indicated that Industry would not only need to think big in terms of scale but also need to:

(i) Invest in R&D and technology.

(ii) Have a continuing commitment for skills development and education.

(iii) Benchmark their performance against best in the industry.

(iv) Adopt best manufacturing practices and production techniques.

(v) Deliver on globally acceptable quality levels.

1.55 In light of the above scenario and goal of making India a hub for small cars, MUVs, two and three wheelers, tractors and components, it becomes essential to focus on the automotive sector and develop a policy specific to the sector which addresses all the constraints. Investment in R&D for technology development will become one of the most important aspects of future strength of this industry. Given India's strength in having the skill sets required to promote technological development, the industry needs to invest in research and development to increase innovative breakthroughs for vehicle design as well as in manufacturing technology and incentivisation of such investments will be needed on the part of the Government.

Demand Creation, Brand Building and Infrastructure

1.56 In order to raise the contribution of the automotive industry to GDP, there has to be a focus both on the domestic market as well as exports. Domestically the focus should be on developing and selling appropriate products for the large population of the country. These products could include cost effective small carriers, strong, rugged, low cost vehicle for the rural market, motorbikes and small, safe four wheelers for family transport. For exports, the focus should be on new geographies for growth beyond traditional markets.

Enhancing Exports

1.57 Export opportunities for four wheelers lie primarily in the small car segment as Indian companies have gained expertise in manufacturing vehicles in this segment and enjoy an advantage over other low cost countries. India should capitalize on this expertise and target becoming a manufacturing hub for A/B class vehicles. This is already being leveraged by OEMs like Hyundai with Santro, Suzuki with Maruti 800/Alto and Tata Motors with Indica. The exports in respect of MUVs, three wheelers and two-wheeler are expected to become substantial in the coming years. Export of other vehicle categories is largely driven by strategies of individual companies. Incentivising the exports, encouraging development of domestic competitiveness, establishing 'Made-in-India' brand are some of the initiatives required to promote International business.

Environment and Safety Regulations

1.58 Emission norms came into force with the Idle Emission Norms in 1984. Mass Emission Norms were introduced in 1991 for petrol vehicles and in 1992 for diesel vehicles. These norms have been progressively made stringent and India has followed the European emission standards and test procedures. Environmental concerns led to India narrowing the gap with Euro norms at a rapid pace and currently BS-II or Euro II equivalent norms are in force throughout the country and BS-III or Euro-III norms in eleven

cities. Two wheelers which play the unique role of family vehicles in India comply with stringent emission norms while at the same time satisfactorily meeting the Indian customer demand for fuel efficiency. Idle emission norms applicable to in-use vehicles have also been tightened. The need is for an appropriate in-use vehicle management policy. Also, a long term emission roadmap needs to be developed. Alternative fuels like Hydrogen and bio fuels need to be promoted to ensure sustainability of the industry over the long term.

Human Resource Development

1.59 Employment is always a major factor when measuring the significance of any economic activity. The automotive industry, on account of its backward and forward linkages, is a significant generator of employment - both direct and indirect. While direct employment is by way of workers engaged in the production of automobiles and auto components, indirect employment is generated in feeder and supplier industries to the automotive industry, such as the vehicle financing and insurance industry, vehicle repair, service and maintenance outfits, automobile and auto component dealers and retailers, vehicle drivers and cleaners, tyre industry, amongst others. Thus steps are needed to ensure that demand — supply gap, both quantitative and qualitative, in terms of human resources, does not arise.

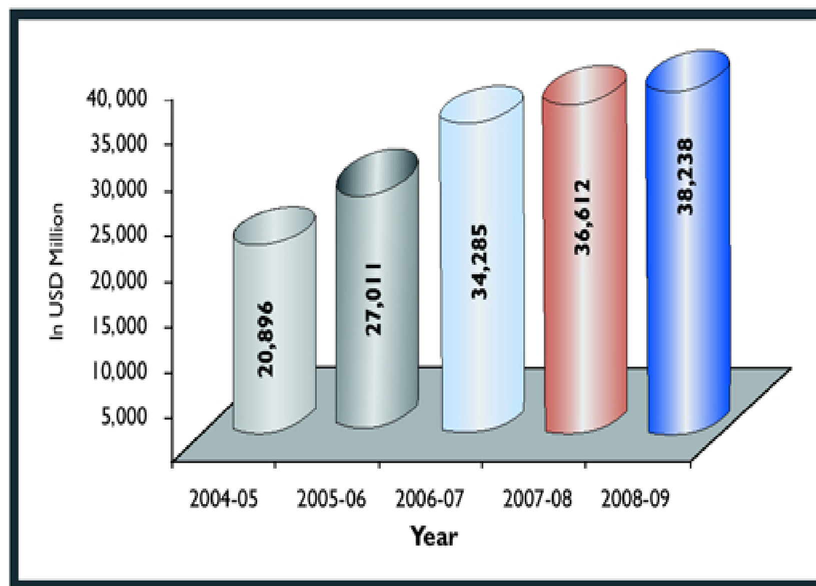
1.60 The need of engineering and managerial manpower is being met by Indian Institutes of Technology (IITs) and Indian Institutes of Management (IIMs). The setting up of a specialized institute for this industry will add to the competitiveness of the industry. The institute, besides developing as a repository of knowledge in the field, will also take up market research and analysis within and outside the country. The Investment Commission has also identified this input as a requirement for the industry. The adoption of existing training institutes by OEMs and setting up of new training institutes by them will be promoted.

Statistical Data

Gross Turnover

Gross Turnover of the Automobile Industry in India	
Year	**In USD Million**
2004-05	20,896
2005-06	27,011
2006-07	34,285
2007-08	36,612
2008-09	38,238

GROSS TURNOVER OF THE AUTOMOBILE INDUSTRY IN INDIA
2004-05 TO 2008-09



Installed Capacity

Installed Capacity	In Millions
Four Wheelers	3.88
Two & Three wheelers	14.31
Engines	0.49

Production Trends

Automobile Production Trends (Number of Vehicles)							
Category	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**	**2010-11**
Passenger Vehicles	1,209,876	1,309,300	1,545,223	1,777,583	1,838,593	2,357,411	2,987,296
Commercial Vehicles	353,703	391,083	519,982	549,006	416,870	567,556	752,735
Three Wheelers	374,445	434,423	556,126	500,660	497,020	619,194	799,553
Two Wheelers	6,529,829	7,608,697	8,466,666	8,026,681	8,419,792	10,512,903	13,376,451
Grand Total	**8,467,853**	**9,743,503**	**11,087,997**	**10,853,930**	**11,172,275**	**14,057,064**	**17,916,035**

Domestic sales Trends

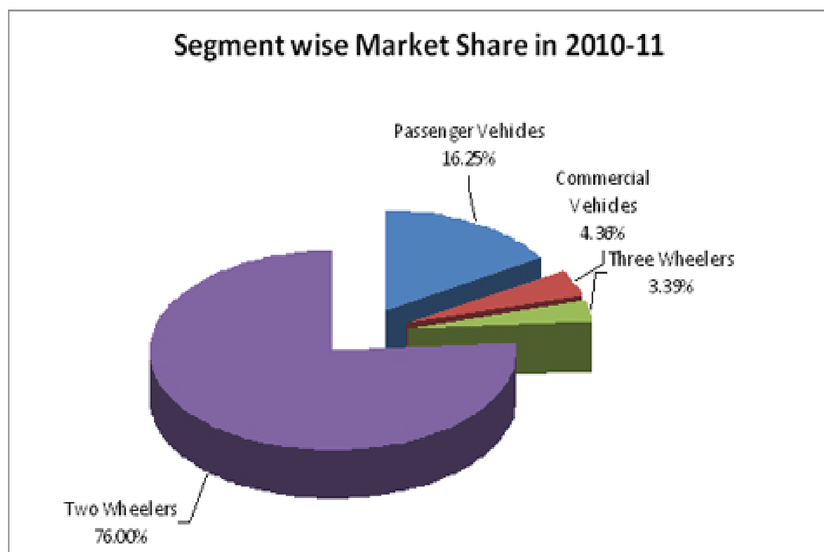
Automobile Domestic Sales Trends (Number of vehicles)							
Category	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**	**2010-11**
Passenger Vehicles	1,061,572	1,143,076	1,379,979	1,549,882	1,552,703	1,951,333	2,520,421
Commercial Vehicles	318,430	351,041	467,765	490,494	384,194	532,721	676,408
Three Wheelers	307,862	359,920	403,910	364,781	349,727	440,392	526,022
Two Wheelers	6,209,765	7,052,391	7,872,334	7,249,278	7,437,619	9,370,951	11,790,305
Grand Total	**7,897,629**	**8,906,428**	**10,123,988**	**9,654,435**	**9,724,243**	**12,295,397**	**15,513,156**

Export Trends

Automobile Exports Trends (Number of Vehicles)							
Category	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**	**2010-11**
Passenger Vehicles	166,402	175,572	198,452	218,401	335,729	446,145	453,479
Commercial Vehicles	29,940	40,600	49,537	58,994	42,625	45,009	76,297
Three Wheelers	66,795	76,881	143,896	141,225	148,066	173,214	269,967
Two Wheelers	366,407	513,169	619,644	819,713	1,004,174	1,140,058	1,539,590

Domestic Market Share

Domestic Market Share for 2010-11 (percentage)	
Passenger Vehicles	16.25
Commercial Vehicles	4.36
Three Wheelers	3.39
Two Wheelers	76



(Source for Statistics: SIAM)

Chapter 2
Regulatory Environment

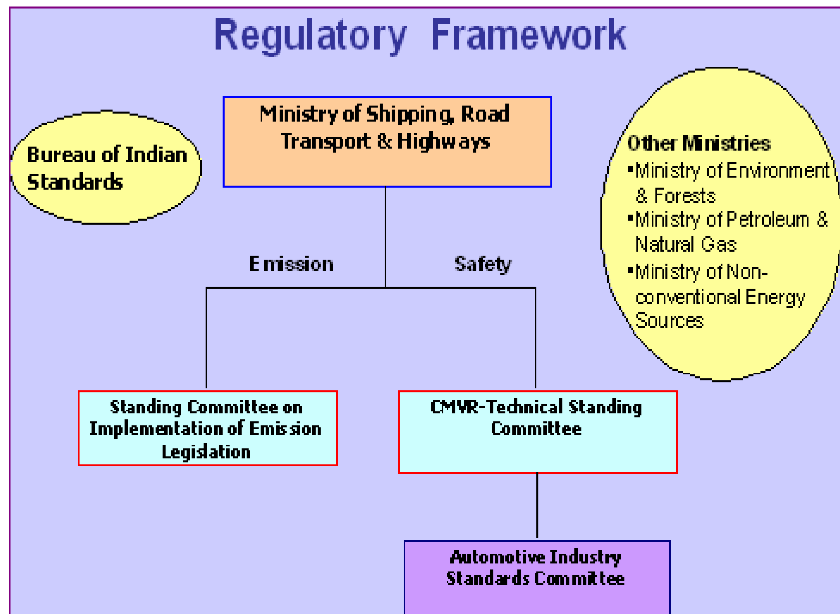
2.1 The Indian auto industry is harmonizing both safety and emission regulations with International Standards for sustained growth of the industry, combating environmental issues and becoming a global export hub.

2.2 India has a well-established regulatory framework under the Ministry of Shipping, Road Transport and Highways in which the Society of Indian Automobile Manufacturers (SIAM) plays a very important role. SIAM is the apex Industry body representing 46 leading vehicle and vehicular engine manufacturers in India.

2.3 All the stake holders are part of the regulation formulation setup. The Ministry issues the notifications under the Motor Vehicles Act, 1988 and Central Motor Vehicle Rules, 1989.

Regulatory Framework

2.4 In India, the rules and regulations related to driving license, registration of motor vehicles, control of traffic, construction and maintenance of motor vehicles etc are governed by the Motor Vehicles Act 1988 (MVA) and the Central Motor Vehicles Rules 1989 (CMVR). The Ministry of Shipping, Road Transport and Highways (MoSRT&H) acts as a nodal agency for formulation and implementation of various provisions of the Motor Vehicles Act and CMVR.



2.5 In order to involve all stake holders in regulation formulation, MoSRT&H has constituted two Committees to deliberate and advise Ministry on issues relating to Safety and Emission Regulations, namely –

I. CMVR- Technical Standing Committee (CMVR-TSC)

2.6 This Committee advises MoSRT&H on various technical aspects related to CMVR. This Committee has representatives from various organisations namely; Ministry of Heavy Industries and Public Enterprises (MoHI&PE), MoSRT&H, Bureau Indian Standards (BIS), Testing Agencies such as Automotive Research of India (ARAI), Vehicle Research Development and Establishment (VRDE), Central Institute of Road Transport (CIRT), industry representatives from Society of Indian Automobile Manufacturers (SIAM), Automotive Component Manufacturers Association (ACMA) and Tractor Manufacturers Association (TMA) and representatives from State Transport Departments. Major functions of the Committee are:

- To provide technical clarification and interpretation of the Central Motor Vehicles Rules having technical bearing, to MoRT&H, as and when so desired.
- To recommend to the Government the international/ foreign standards which can be used in lieu of standards notified under the CMVR and permit use of components/parts/assemblies complying with such standards.
- To make recommendations on any other technical issues which have direct relevance in implementation of the CMVR.
- To make recommendations on the new safety standards of various components for notification and implementation under CMVR.
- To make recommendations on lead time for implementation of such safety standards.
- To recommend amendment of CMVR having technical bearing keeping in view of Changes in automobile technologies.

2.7 CMVR-TSC is assisted by another Committee called the ***Automobile Industry Standards Committee (AISC)*** having members from various stakeholders in drafting the technical standards related to safety. The major functions of the Committee are as follows:

- Preparation of new standards for automotive items related to safety.
- To review and recommend amendments to the existing standards.
- Recommend adoption of such standards to CMVR Technical Standing Committee.
- Recommend commissioning of testing facilities at appropriate stages.
- Recommend the necessary funding of such facilities to the CMVR Technical Standing Committee, and

- Advise CMVR Technical Standing Committee on any other issues referred to it.

2.8 The National Standards for Automotive Industry are prepared by Bureau of Indian Standards (BIS). The standards formulated by AISC are also converted into Indian Standards by BIS. The standards formulated by both BIS and AISC are considered by CMVR-TSC for implementation.

II. Standing Committee on Implementation of Emission Legislation (SCOE)

2.9 This Committee deliberates the issues related to implementation of emission regulation. Major functions of this Committee are –

- To discuss the future emission norms.
- To recommend norms for in-use vehicles to MoSRT&H.
- To finalise the test procedures and the implementation strategy for emission norms.
- Advise MoSRT&H on any issue relating to implementation of emission regulations.

2.10 Based on the recommendations from CMVR-TSC and SCOE, MoSRT&H issues notification for necessary amendments / modifications in the in Central Motor Vehicle Rules.

2.11 In addition, the other Ministries like Ministry of Environment & Forest (MoEF), Ministry of Petroleum & Natural Gas (MoPNG) and Ministry of Non-conventional Energy Sources are also involved in formulation of regulations relating to Emissions, Noise, Fuels and Alternative Fuel vehicles.

Automobile Research Association of India (ARAI)

2.12 ARAI is a co-operative industrial research association established by the automotive industry with the Ministry of Industries, Government of India. ARAI is the nodal center for research and development in the automotive field and is committed to provide research and development, testing,

certification and calibration support for developing safe, reliable and eco-friendly vehicles / components and harmonize Indian automotive standards to global standards. A certificate from ARAI is a pre-requisite before any new vehicle model is permitted to ply on the roads.

2.13 The main activities of the ARAI are:

- Carry out sponsored Research and Development projects for the industry / Government of India / national and international agencies.
- Certification of vehicles and components as a notified agency as per the Central Motor Vehicle Rules.
- Formulation of automotive standards.
- Participation in national and international forums in the automotive technology and related fields.
- Carry out own Research Projects in automotive technology.

Vehicular Safety Standards and Regulations

2.14 Environmental imperatives and safety requirements are two critical issues facing the automotive industry, worldwide. Indian Automobile Industry in the last decade has made significant progress on the environmental front by adopting stringent emission standards, and is progressively aligning technically with international safety standards.

2.15 CMVR came into force from 1989 and serious enforcement of regulations came into effect. Chapter V of the CMVR, 1989 deals with construction, equipment and maintenance of vehicles and in addition to rules governing emission limits, there are several rules in this chapter requiring motor vehicles to comply with safety regulations.

2.16 Vehicles being manufactured in the country have to comply with relevant Indian Standards (IS) and Automotive Industry standards (AIS). Indian Standards (IS) have been issued since the

late 1960s and these standards for Automotive Components were based on EEC/ISO/DIN/BSAU/FMVSS etc at that time.

2.17 Regulations are reviewed periodically by the Technical standing Committee on MCVR (CMVR-TSC).

2.18 States also have their State Motor Vehicle Rules.

2.19 Since 2000 ECE Regulations have been used as basis for Indian regulations and since 2003, increased efforts are being made to technically align with ECE. Variance from ECE exists on formatting phraseology and administration related issues.

Harmonisation

2.20 At present vehicles sold in a country have to meet the regulations and standards of that country. This requires approvals or approval of a vehicle and / or its components according to the procedure of the Government of that country. With the globalisation of the automobile industry, vehicle and vehicle parts are being internationally traded these days. The existence of separate regulations and approvals procedures in different countries requires design modifications, added tests and repetitive approvals.

2.21 To address this situation and to assist the global trade of automobiles and their components, efforts are being made to have harmonised vehicle regulations worldwide. The major role in this direction is being played by Working Party (WP) 29 under United Nations Economic Commission for Europe (UNECE).

2.22 WP.29 was established on 6th June 1952 as Working Party 29 and is presently known as the World Forum for Harmonisation of Vehicle Regulations under the Inland Transport Committee of the United Nations Economic Commission for Europe. The objective of the WP.29 is to initiate and pursue actions aiming the harmonisation or development of technical regulations, which may be accepted worldwide. These regulations are directed at improving vehicle safety, protecting the environment, promoting energy efficiency and anti-theft

performance, providing uniform conditions for periodical technical inspections and strengthening economic relations world-wide.

2.23 WP.29 administers two UNECE Agreements on harmonisation of vehicular regulations, namely -

1. UNECE 1958 Agreement Concerning the Adoption of Uniform Technical Prescriptions for Wheeled Vehicle, Equipment and Parts Which Can be Fitted and / or be Used on Wheeled Vehicles and the Conditions for Reciprocal Recognition of Approvals Granted on the Basis of These Prescriptions.

   This Agreement was made under UNECE with an objective of establishing uniform technical prescriptions for vehicles and their components relating to safety, environment, energy and anti-theft requirements. The Agreement aims to promote the harmonisation of vehicle regulations and the mutual recognition of type approvals amongst Contracting Parties to the Agreement. The Agreement in its original form allowed participation of only UNECE members. It was revised in 1995 to promote non-European participation.

2. UNECE 1998 Agreement Concerning the Establishing of Global Technical Regulations for Wheeled Vehicles, Equipment and Parts Which Can be Fitted and /or be Use on Wheeled Vehicles.

   The 1998 Agreement runs parallel to the 1958 Agreement and establishes a process through which countries from all regions of the world can jointly develop Global Technical Regulations (GTRs) for vehicles and their components.

2.24 The aim of the Agreement is to promote participation of various countries in the formulation of Global Technical Regulations, but, contrary to the 1958 Agreement, no provisions are given regarding the acceptance of mutual recognition of approvals.

2.25 The regulations being formulated under this Agreement are known as *Global Technical Regulations*.

2.26 India is gradually harmonising its automotive standards with global norms, giving due cognizance to the prevailing national concerns. The Union Cabinet also approved the constitution of a National Level Standing Committee to deal with issues pertaining to WP.29.

2.27 Earnest efforts are underway for a meaningful participation in the deliberations of WP.29 and its subsidiary bodies. Experts from India have been regularly participating in sessions of WP.29 and its subsidiary bodies. The government is currently in the process of taking a decision regarding joining one or both of the 1958 / 1998 Agreements.

Emission Norms

2.28 The automobile industry has to address the following issues at all the stages of vehicle manufacture:

- Environmental Imperatives.
- Safety Requirements.
- Competitive Pressures, and
- Customer Expectations.

2.29 There is a strong interlinking amongst all these forces of change, influencing the automobile industry. These have to be addressed consistently and strategically to ensure competitiveness.

2.30 Since pollution is caused by various sources, it requires an integrated, multidisciplinary approach. The different sources of pollution have to be addressed simultaneously in order to stall widespread damage.

2.31 Parameters determining emissions from vehicles:

- Vehicular Technology.
- Fuel Quality.
- Inspection and Maintenance of In-Use Vehicles.

- Road and Traffic Management.

2.32 While each one of the four factors mentioned above have direct environmental implications, the vehicle and fuel systems have to be addressed as a whole and jointly optimised in order to achieve significant reduction in emission.

Vehicular Technology

History of Emission Norms in India

2.33 The significant environmental implications of vehicles cannot be denied. The need to reduce vehicular pollution has led to emission control through regulations in conjunction with increasingly environment-friendly technologies.

2.34 The first Indian emission regulations were idle emission limits which became effective in 1989. These idle emission regulations were soon replaced by mass emission limits for both petrol (1991) and diesel (1992) vehicles, which were gradually tightened during the 1990s. Since the year 2000, India started adopting European emission and fuel regulations for four-wheeled light-duty and for heavy-dc. Indian own emission regulations still apply to two- and three-wheeled vehicles.

2.35 Bharat Stage emissions standards are emissions standards instituted by the Government of India that regulate the output of air pollutants (such as nitrogen oxides, carbon monoxide, hydrocarbons, particulate matter, soot, and, where applicable, sulfur oxides) by internal combustion engine powered equipment, including motor vehicles, or other air polluting facilities or equipment. In many cases they are similar to European emissions standards.

2.36 Since India embarked on a formal emission control regime only in 1991, there is a gap in comparison with technologies available in the USA or Europe. Currently, we are behind Euro norms by a few years, however, a beginning has been made, and emission norms are being aligned with Euro standards and vehicular technology is being accordingly upgraded. Vehicle

manufactures are also working towards bridging the gap between Euro standards and Indian emission norms.

Overview of the Emission Norms in India

- 1991 - Idle CO Limits for Gasoline Vehicles and Free Acceleration Smoke for Diesel Vehicles, Mass Emission Norms for Gasoline Vehicles.
- 1992 - Mass Emission Norms for Diesel Vehicles.
- 1996 - Revision of Mass Emission Norms for Gasoline and Diesel Vehicles, mandatory fitment of Catalytic Converter for Cars in Metros on Unleaded Gasoline.
- 1998 - Cold Start Norms Introduced.
- 2000 - India 2000 (Equivalent to Euro I) Norms, Modified IDC (Indian Driving Cycle), Bharat Stage II Norms for Delhi.
- 2001 - Bharat Stage II (Equivalent to Euro II) Norms for All Metros, Emission Norms for CNG and LPG Vehicles.
- 2003 - Bharat Stage II (Equivalent to Euro II) Norms for 13 major cities.
- 2005 - From 1 April Bharat Stage III (Equivalent to Euro III) Norms for 13 major cities.
- 2010 - Bharat Stage III Emission Norms for 4-wheelers for entire country whereas Bharat Stage - IV (Equivalent to Euro IV) for 13 major cities. Bharat Stage IV also has norms on OBD. (similar to Euro III but diluted)

(Source: ECMA)

Emission Testing in India

2.37 In India, the idle emission test has been introduced since mid-eighties. Only CO was tested (% Vol) from gasoline cars and vehicle had to meet a limit of 3.0% for passing the test. The idle CO emission checking process is a world-wide accepted quick and easy method to indicate if the vehicles emission control is within the acceptable performance requirement. A vehicle with improper combustion is in most cases likely to fail the idle CO test. Thus the vehicle could be advised to go to a workshop for suitable maintenance.

2.38 This process has been in force for about 20 years in the country. Euro II emission-technology norms were first introduced in certain cities from April 1, 2000, as a result of which most of the vehicles were equipped with a three-way catalytic converter and a closed loop feedback system. It is very critical that the air/fuel ratio in these vehicles is maintained at the stoichiometric levels. This would ensure that the catalytic converters efficiency for converting all the three pollutants, carbon monoxide, hydrocarbons, and oxides of nitrogen is the highest.

2.39 It is well accepted by automobile companies that while for carburetted cars, simple idle test can identify malfunctioning systems, the same does not hold for cars, which are equipped with catalysts. Modern cars equipped with electronic fuel injection and ignition systems and three-way catalysts may have defects — such as defective sensors and degraded catalyst efficiency — that may not show up in idle tests. Thus given the inherent disadvantages of the idle tests, the first step should be to move towards an improved system which would mandate measurement of all the four gases and the lambda for catalyst-equipped cars at high idle (accelerated driving speeds).

2.40 Lambda is a dimensionless value representative of the burning efficiency of an engine in terms of the air/fuel ratio in the exhaust gases and determined with a referenced standardized formula. Lambda represents actual to stoichiometric air/fuel ratio.

2.41 Lambda measurement is absolutely critical, as the new generation vehicles fitted with catalytic converters requires that the lambda be maintained within its range. Lambda measurement checks the performance of the fuel air mixture preparation system. For a well-tuned/maintained vehicle lambda value should be 1 ± 0.03 in the range 0.97 to 1.03 as per international norms/practices. Any value beyond this range indicates faulty mixture preparation or poor performance of mixture preparation system. If the value were not in the specified lambda range, it would also result in sub optimal performance of the catalytic converter. For catalyst-equipped cars, a lambda test may be

coupled with an idle/fast idle test in order to check the performance of the mixture preparation system.

Fuel Technology

2.42 Fuel quality plays a very important role in meeting the stringent emission regulation.

2.43 The fuel specifications of gasoline and diesel have been aligned with the Corresponding European Fuel Specifications for meeting the Euro II, Euro III and Euro IV emission norms.

2.44 There is a need for a holistic approach so that upgradation in engine technology can be optimised for maximum environmental benefits.

Inspection and Maintenance (I&M) of In-use Vehicles

2.45 At any point of time, new vehicles comprise only 8% of the total vehicle population. In India currently only commercial vehicles are required to undergo periodic fitness certification. The renewal period for fitness certification in general is 2 years for new commercial vehicles and every 1-year for old vehicles. For private vehicles no mandatory periodic fitness check is required in India but there exist a system of re-registration of private vehicles after 15 years of initial registration or 1st registration. Thus, after 15 years a private vehicle has to go for fitness to get re-registered which remains valid for the next five years Pollution Under Control (PUC) is the existing system of periodic I&M in India which is a mandatory requirement for all categories of on-road vehicles including two wheelers. Under this system a PUC certificate is issued for a vehicle upon conformity to emissions based on idle test for Gasoline vehicles and free acceleration smoke test for diesel vehicles.

2.46 In most countries that have been able to control vehicular pollution to a substantial extent, Inspection and Maintenance of all categories of vehicles have been one of the chief tools used. Developing countries in the South East Asian region, which till a few years back had severe air pollution problem have introduced an I&M system and also effective traffic management

Chapter 3
Revenue

3.1 Revenue accounting in the automotive industry is a complex process and requires considerable level of professional judgment.

Revenue in the automotive industry consists of the following:

a) Revenue from sales of goods and sales of services.

b) Revenue from customer financing.

A. Revenue from sales of goods and sales of services

3.2 Sales consist of the following:

- Sales of goods;
- Sales of services;
- Royalty income;
- Commission income; and
- Maintenance and service contracts.

B. Revenue from financing, leasing, etc.

3.3 Revenue from financing/leasing consists of the revenue generated from financing/leasing facilities given to the dealers or ultimate users either directly by the manufacturer or by a financing Company. It includes the following:

- Interest income on financing to dealers;
- Interest income on installment credit granted to ultimate users;
- Interest income from finance leases;

- Rental income from operating leases; and
- Amortization of subsidies received from the manufacturers on low-rate financing to ultimate users in the case of financing companies only.

This Guide deals with the audit of the above mentioned types of revenue covered under Accounting Standard (AS) 9, Revenue Recognition, as well as Accounting Standard (AS) 19, Leases notified under the Companies (Accounting Standard) Rules, 2006.

Point of Recognition of Revenue

3.4 As stated in AS 9 regarding the sales of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) The seller of goods has transferred the property in the goods or all significant risks and rewards of ownership to the buyer for a price and seller retains no effective controls associated with ownership of the goods transferred; and

(ii) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

3.5 Revenue should be recognized when the above mentioned conditions related to the performance are satisfied provided that at the time of performance it is reasonable to expect the ultimate collection. If at the time of raising of any claim, it is unreasonable to expect the ultimate collection, recognition of revenue should be deferred.

3.6 In the case of rendering of services, performance should be regarded as achieved when no uncertainty exists regarding the amount of the consideration that will be derived from rendering that service.

3.7 Sales in the automotive industry can be further categorized as follows:

1. Direct Sales by Manufacturer to the ultimate customer.

2. Sales to Dealers by the Company.

3. Sales to institutional parties.

4. Export sales.

3.8 While auditing the revenue booked by the manufacturer, it is essential to review the terms of the agreement entered into between the buyer and the seller and the time when revenue is booked.

3.9 The auditor has to ensure that at the time of booking the revenue, as required by AS 9, all the significant risks and rewards related to the goods sold have been transferred to the buyer, which may not necessarily coincide with the transfer of property in the goods. It should be ensured that the sale is not in the nature of consignment sales or stock transfer.

3.10 In an automotive industry, sales volumes are usually fixed for the sales team and are closely monitored by the higher management. This, in turn, leads to an inherent risk of sales being booked or goods being dumped at the dealers' premises (forced sales) without adequate purchase orders. It is imperative for the auditor to obtain the copies of the agreement entered between the dealer and the Company in order to ensure the point of time at which all the significant risks and rewards have actually been transferred. If the agreement is silent about transfer of significant risks and rewards, the auditor should use his professional judgment to ensure that the revenue is accounted for appropriately. Further, the sales return should be tested and ensured that these do not related to dumped (forced) sales which are getting reversed in the next period. If that be the case, it should be ensured that the original sale is reversed. There might also be cases where sales are booked and the delivery of the vehicles has not been made as of the cut-off date. In case, where the sales are booked but the delivery has not been made as of the cut-off date, the auditor should obtain confirmations from the dealers confirming the passing of risks and rewards of the vehicles. The important conditions which should be considered in

determining whether the significant risks and rewards have been transferred or not are listed as follows:

a) Who bears the future price risk.

b) Who bears the risk in case the goods are damaged subsequently, including obsolescence.

c) Who bears the credit risk.

Institutional Sales

3.11 Institutional sales in the automotive industry mainly comprise of Government rate contracts and sales to military and para-military forces, Public Transport Agencies, Police and other Government departments. The contracts are characterized by a fixed price for specific models, stringent inspection procedures of agencies designated by Government and adherence to stringent time schedule. Liquidated damages are imposed if the seller fails to meet the deadline. Sometimes Government departments even require certain specifications suitable to their own needs like for example, in the case of sales to the Military, the vehicles are different than those used for the general civic society.

3.12 The nature of the institutional sales, described above, gives rise to following inherent risks:

a) Contract becoming onerous in case the cost of production increases and the agreed rates, usually of long term in nature, are lower than the actual cost.

b) Inventory obsolescence as large number of items are required to be kept for specific models.

c) Inappropriate booking of revenue which should be done only after the inspection formalities are over and as per the terms of the contracts.

d) Unaccounted liquidated damages or retention money. Receivables from Government agencies need a thorough scrutiny in order to ensure that there are no unaccounted liquidated damages or retention money deduced by these

departments. Retention money is very often deducted by these agencies for future warranties and services.

Export Sales

3.13 In case of export sales, the time of booking the revenue is very important as it is based on the terms mentioned in the agreements entered into for export sales such as sales to be ex-factory or free on board or delivery at client location including the testing to be done at the buyer's end. To mitigate the risk inherent in these areas, the sale agreements should be studied in detail and the audit should be conducted having regard to the substance of the transactions.

Incentives, Discount Schemes and Other Marketing Schemes to Dealers and Customers

3.14 Another important aspect of the automotive industry is various kinds of marketing schemes offered by the manufacturers from time to time.

The various types of incentives and discount schemes offered by the seller are listed as follows:

1. Rebates including volume discount.
2. Cash discounts.
3. Free gift items.
4. Free insurance.
5. Loyalty bonus.
6. Free after sales services, etc.

3.15 Computation of the value of the incentive and discount schemes should be checked while auditing.

3.16 The incentives/discount schemes can be classified into two types. They are stated as follows along with their accounting treatment:

a) **Schemes which are computed on the basis of sales value** – These should be grouped under rebates and deducted directly from the total sales amount. For example, if a customer has made bulk purchases entailing to a volume discount, bonus or other similar incentives, this should be treated as a reduction in the sales value (i.e. a rebate), even if it is processed separately from the regular invoicing.

b) **Schemes which are not computed on the basis of sales value** – These should be included in selling expenses. For example, incentives not related to the scope of the purchase and have other measures, such as certain advertising undertakings.

Distinction between Rebates, Volume Discounts and Re-Imbursement of Selling Expenses

3.17 The main distinction between rebate and volume discount is that while rebates are based on the sales value, volume discount is based on the quantities of goods sold. Whether a discount or rebate should be netted off against revenue depends on the nature of the discount rather than whether the amounts are determined based on sales value. Broadly, if the nature of the discount/rebate is towards adjustment of price, the same needs to be adjusted against revenue. However, if the nature is such that it is towards sale incentives or commission or sale promotion re-imbursements of certain expenses incurred by dealers such as on advertising etc., the same should be grouped as a sale promotion expense. The treatment given for these types of discounts/commissions etc. for the purpose of excise duty/tax deduction at source etc. can also be evaluated and corroborated to ensure that the treatment of such items is given on a consistent basis.

3.18 The auditor should ensure that all the schemes are properly authorized and there are adequate internal controls for monitoring the accounting and issuance of credit notes in respect of these schemes. At the reporting date the auditor should ensure that an appropriate accrual has been made in the books of account for incentive schemes.

3.19 The auditor should obtain the list of all the schemes floated during the year and ensure that the client has an appropriate log of all these schemes. Often the accrual for such discounts/rebates/re-imbursements etc. requires estimation by the Company. The auditor should understand the process followed by the Company in arriving at the estimates and the assumptions used in arriving at these estimates while testing the accrual for these incentives/re-imbursements.

3.20 The auditor should also ensure that there are no special preferences given to any particular dealer in any of the scheme and the schemes are common for the dealers. However, the scheme may differ from region to region and product to product based on market dynamics but should be common for the dealers serving the region or a product. Key performance criteria for availing benefits under such schemes must be clearly stipulated in the scheme and it must be verified that dealers to whom these benefits are allowed, have met all the conditions as required by the scheme.

3.21 The auditor should ensure that the entity has maintained proper segregation of duties so that persons approving the credit notes for these schemes are not from the marketing department but are from the finance/accounting department.

Cash Discount

3.22 While auditing the sales, the auditor should ensure that the cash discounts given by the seller are not deducted from the total sales amount but are included under other operating expenses. Further, the auditor should check that the discount has been allowed on the basis of the actual cash received from the customers and not on any other parameters like sale value or volume/quantity. If the latter is the case, then the discount should be considered as any other rebate and should be deducted from the total sales value.

Illustration for accounting and computation of schemes

A Company has offered following schemes to its dealers:

a. Annual target @1% of total sales value if more than 100% of sales target is achieved.

b. Free gifts including automotive accessories given at the time of sales.

c. Cash discount on payment within 2 weeks.

d. Reimbursement to the dealer for free insurance provided to ultimate customer, and

e. Free after sales services for a period of 1 year to the ultimate customer.

The Company needs to create a provision for expense against all these schemes as and when the sale is incurred on the basis of their nature.

As per the guidance given above, expense related to annual target scheme needs to be deducted from revenue and expenses related to other schemes should be booked under selling expenses. Further, in case of schemes for which the Company has identified the value at the time of sales and has shown these charges separately in the invoice, these should be taken directly to liabilities.

Basis of computation of scheme value

Target rebate: Based on the performance of the dealers in current year and in prior years, e.g. in the prior three years, 90%, 80% and 70% dealers have achieved the sales more than target. So, on an average of last three years, 80% dealers have achieved more than the target. If the Company has to compute the target rebate for any interim date, estimated sales value of those dealers who are likely to exceed targets during the current year should be considered for computation of target rebate expense which should be deducted from revenue.

Free gift including automotive accessories: Actual cost of

these materials should be booked as expense immediately when the sale is incurred.

Cash discount: It should be booked on the basis of actual cash received from the customer or the past experience of receipt of payments from that customer should be analyzed for booking of expense on an estimated basis.

Free insurance: Actual/estimated expenses to be borne by the Company for free insurance should be booked.

After sales services: On the basis of actual/estimated cost to be reimbursed by the Company to the dealers after considering the percentage of claims received in the prior years. Further, as stated above, if the value of services in known at the time of sales, then the amount should be deducted from the revenue and should be taken directly to the liabilities as deferred revenue.

Note: Wherever estimates are made, the same should be trued up when the actuals are known.

3.23 In addition, sometimes companies float schemes such as festive schemes for the ultimate customers. Companies agree to bear the scheme cost on the stock lying with the dealers on the day of announcement of the scheme. In such circumstances, the auditor should ensure that if the dealers have some stock lying at their premises related to the sales made by the Company before the announcement date, then provision has been made in the books of the Company for the expense against such sales.

Annual Maintenance Contracts

3.24 Annual maintenance contracts are after sales services provided to customers to cover the future maintenance of products sold.

3.25 Revenue from annual maintenance contracts should be deferred and recognized as income on a straight-line basis over the contract period except where empirical data is available which indicates that the costs of performing services under the contract

are incurred other than on a straight-line basis. In such cases, revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

Extended Warranty

3.26 An extended warranty sometimes called a service agreement, a service contract, or a maintenance agreement is a prolonged warranty offered to consumers to cover products under specific conditions for an agreed period and/or content in addition to the standard contractual warranty. For e.g. an extended warranty scheme may cover a period (say one year or 2 years) beyond the free warranty service period. In the automobile industry, an extended warranty generally covers all mechanical and electrical failures and labour for these repairs. An extended warranty may be sold as a part of the original sale of product or as a separately priced extended warranty contract.

3.27 Revenue from extended warranty maintenance contracts should be deferred and amortized to income on a straight-line basis over the extended warranty contract period except where sufficient past evidence is available which indicates that the cost of performing service under the contract is incurred other than on a straight-line basis. Therefore where the extended warranty is for a period of two years beyond the free warranty service period, the extended warranty amount collected should be recognized as income over two years after completion of the free warranty period.

3.28 If, however, the costs incurred or to be incurred to service the extended warranty contract cannot be measured reliably, revenue is not recognized. This criterion flows from the matching principle. Therefore, warranty costs should be estimated and accrued. If such costs cannot be estimated reliably, revenue is deferred until the amount of such expenses can be more reliably estimated or have been incurred. In these circumstances, any consideration already received from the sale of the extended warranty is recognized as a liability.

3.29 As per the requirements of AS – 29 Provision, Contingent Liabilities and Contingent Assets, loss on an onerous extended warranty contract should be recognized immediately if the future expected cost of providing services under such contract exceeds the revenue.

Illustration

A Company has charged Rs. 100,000 for extended warranty provided to a customer for a period of 10 months of free after sales service which covered labour expense only. As per the guidance given above, Rs.10,000 per month should be taken to income every month on the time/straight-line basis during the extended warranty contract period.

Further, as per past experiences, if the Company believes that the cost to be incurred against extended warranty contract will be Rs. 120,000, then the loss of Rs. 20,000 should be provided for in the books immediately and revenue of Rs. 10,000 and cost of Rs.10,000 (or at actuals, whichever is higher) should be booked every month.

3.30 The auditor should obtain a schedule of all such extended warranty schemes given by an entity during the year and ensure that both revenue and costs pertaining to such schemes have been properly booked.

Low-rate/ Subsidized Financing to Ultimate Users

3.31 Subsidies granted by automobile companies to finance companies to facilitate wholly or partially for low-rate financing arrangements granted to ultimate users are basically discounts granted to ultimate users. More automobile companies are starting to offer incentives on leasing to the ultimate users. Such leasing incentives are called lease subvention. Such expenses should be provided for and should be treated as sales rebates in the financial statements.

Factoring Fees

3.32 Factoring fees mainly include servicing costs and finance costs.

3.33 In case of factoring arrangements where the receivables are retained in the balance sheet, the finance or interest cost portion of the factoring fee should be included under "Interest expenses". The service costs portion of factoring fees should be accounted for as "Selling expenses".

3.34 The auditor should ensure that the entity maintains a proper record of such arrangements. The auditor should ensure that a schedule is prepared by the entity for all such arrangements and ensure that the service costs and finance costs are accrued and accounted properly.

Used Products Traded-in for New Products

3.35 In cases where a used product is traded as a part of the payment for the sale of a new product, the product which is traded-in should be recorded in inventories using its market value as the cost of inventory. The difference between this market value along with any other amount received or receivable and the purchase price offered to the customer should be reported as a rebate in the selling price of the new product sold. If a subsequent decrease in the market value of the product traded-in happens, the decrease should be reported as a loss in the value of inventories, in accordance with Accounting Standard – 2 "Valuation of Inventories.

3.36 The auditor while carrying out audit procedures should ensure that there is proper documentation for assessing the market value of traded-in products.

Barter Transactions

3.37 Transactions under barter system normally entitle a Company receiving products not related to its operations as payment, in full or in part, for the goods which are sold.

3.38 When goods or services are exchanged for dissimilar goods or services, a transaction that generates revenue has taken place and revenue is recognized. The revenue is measured at the fair value of the goods or services received, adjusted for any cash payments made by either the buyer or the seller. If the fair value of the goods or services received cannot be measured reliably, revenue is recognized at the fair value of the goods or services given up, adjusted for any cash payments made or received.

3.39 For all barter transactions, the auditor should obtain a list of such contracts and ensure that there is a proper authorization for such products. The auditor should also ensure that there is a proper system for valuation of such products. At the reporting date, the auditor should evaluate that all such contracts have been duly considered in the accounts, wherever necessary.

Residual Value Commitments

Definition

3.40 A transaction which legally constitutes a sale, i.e. the risk and reward of the product is shifted to the customer, but the seller gives a commitment to the buyer for some value in future of the used product through a contract. The residual value commitment may be made to various parties including ultimate customer, dealer, to a customer financing company etc.

Examples

3.41 Followings are examples of various types of residual value commitments:

a. **Buy-back agreements:** The customer has the option to resell the used product to the seller at a stipulated future date. The price for re-sale is agreed upon at the time of sale.

b. **Multiple buy-back agreements:** Similar to an agreement mentioned above, with the difference that the buyer may choose between several dates in the future to resell the used product to the seller.

c. **Trade-back agreements:** This agreement is also similar to buy-back agreement with the difference that the buyer has to accept a new product to exercise his option to re-sell the product.

3.42 Minimum value guarantees agreements: These have a right vested with the customer to get the compensation from the seller in case the value received at the time of disposal of the used products is lower than a certain price determined initially at the time of the sale. The difference between a buy back agreement and this agreement is that in these arrangements, the customer is responsible for the disposal of the used products.

3.43 Return Rate: While making the agreements for residual value commitments, the seller generally retains a risk for the future price levels of the used products. The risk is actualized if:

- the customer exercises the option to re-sell the used product (in case of buy back agreements), and
- the customer has the right to receive a fixed compensation at the time of disposal of the used product (in case of minimum value guarantees agreements).

3.44 Basically, this return rate measures as to what extent this type of risk had been realized in the past. The return rate is a percentage and may be calculated by applying following formula:

$$\frac{\text{Number of products with realized risk}}{\text{Number of products with expired risk}} = \text{Return rate (\%)}$$

Number of products with expired risk covers all the products sold in the same period with an expired residual value agreements commitment, irrespective of whether any risk has been realized or not.

Sales Recognition with Residual Value Agreements

3.45 Sales of products which are combined with residual value commitments (buy-back contracts in future) or may be recognized

as sales at full value or may be accounted for as an "operating lease".

3.46 The auditor should verify the terms and conditions of residual value agreements to ascertain if the seller has transferred all the significant risks and rewards of ownership to the buyer (As per the requirements of AS – 9). If the significant risks and rewards are transferred, sales should be recognized immediately. In a scenario where legal title has been transferred but the seller has retained all the significant risks and rewards, the transaction is in the nature of an operating lease and should not be recognized as sales.

3.47 Transactions involving residual value commitments should be recognized as sales if any of the criteria given below are fulfilled:

A. ***Value of residual commitment is not significant as compared to the initial sales price of the product:***

3.48 Normally, if the residual value commitment covers less than 10% of the sales price of the product, the transaction should be accounted for as a sale. E.g. If a vehicle's sales price is Rs. 5,000 and the customer can resell the same for Rs. 400, the initial transaction should be accounted for as sales.

3.49 For the purpose of the above calculation, the residual value commitment should be discounted to the present value using the discount rate the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

B. A separate agreement, independent from the original sales contract has been entered into for the residual value commitment.

3.50 Example: A finished good is sold to a dealer. After that a customer financing Company enters into a contract with the end customer. The initial sales transaction should be recognized as sales if it is independent from the second transaction. A contract shall be treated as an independent contract if:

- A separate contract is entered between the entity and the dealer without any residual value commitments,
- Subsequently, a separate financing contract is entered between the end customer and a customer financing Company. The customer has other financing options different from the customer financing Company and has no binding limitations in making this decision.

C. A contract in the nature of trade back

3.51 Sales transactions which are combined with trade-back arrangements should be recognize as sales.

3.52 If none of the above conditions are fulfilled, the transaction should be recognized as an operating lease. This recognition is further illustrated in the box given in the following page:

Illustration for operating lease (All amounts in Rs.)

<u>**Assumptions:**</u>

A product is sold to a customer. In connection with this sale, a buy-back contract is entered with the customer. This transaction does not fulfill the conditions as mentioned as per the guidance to be recognized as a sales transaction and, hence, would be covered through operating lease.

Price	5,000 (fully paid at sale)
Product cost	4,250
Residual value commitment (buy-back value)	2,750 (after three years)
Initially estimated net realizable value	2,600 (after three years)
Price ultimately realized on sale of used product	2,625

Accounting:

Statement of profit and loss	**At Sale**	**First Year**	**Second Year**	**Third Year**	**Used Vehicle Sale****
Lease Income	-	750	750	750	-
Sale of used product	-	-	-	-	2625
Lease income/ Net sales	-	750	750	750	2625
Depreciation	-	(550)	(550)	(550)	-
Cost of used product	-	-	-	-	2600
Gross income	-	200	200	200	25
Balance Sheet:*					
Assets:					
Assets under operating lease	4,250	(550)	(550)	(3,150)	-
Inventory	(4250)	-	-	2,600	(2,600)
Cash	5,000	-	-	(2,750)	2,625
Liabilities:					
Shareholders' equity	-	200	200	200	25
Deferred Leasing income	2,250	(750)	(750)	(750)	-
Residual value liability	2,750	-	-	(2,750)	-
Operating Cash flow	5,000	-	-	(2,750)	2,625

* The amounts reflect the change of balance sheet values during the different periods

** Assuming that the customer utilizes the buy-back option.

Leasing income: The difference between the initial sales price and the buy-back value is accrued over the agreement period and accounted for as leasing income. The amount of leasing income credited to the statement of profit and loss should be debited to deferred leasing income.

Illustration of operating lease

Depreciation: The difference between the product cost and the estimated net realizable value of the product at the end of the commitment period (Agreement) is depreciated over a straight-line basis. For the debit to depreciation there should be a corresponding credit against the value of assets under operating leases.

Accounting at the expiry of a contract if the product is not repurchased:

If, at the end of the commitment period, the customer decides to utilize the buy-back option, the product is reclassified as inventory and the sale of the used product is recorded as a regular sales transaction.

If, at the end of the commitment period, the customer decides not to utilize the buy-back option, the "Residual value liability" should be reversed and recognized as "Net Sales" (i.e. 550 in the example). Simultaneously, the remaining balance of "Assets under operating leases" should be reversed and recognized as "Cost of Sales" (i.e. 520 in the example).

Accordingly, these postings would result in an additional gross profit of 30 being recognized in the income statement. Operating cash flow is not affected under this scenario.

Residual Value Losses

Definitions

Residual Risk

3.53 Residual risk is the possibility that the amount the seller obtains from returned vehicles will be less than the estimate of the expected residual value for the vehicle.

Residual Value Losses

3.54 Residual value losses are the future expected losses on the sale of used products that are returned from the buyer under a residual value commitment agreement.

3.55 The expected residual value is usually evaluated by recent auction values, return volumes for leased vehicles, industry-wide used vehicle prices, marketing incentive plans, and vehicle quality data.

Net Realizable Value (NRV)

3.56 NRV is the estimated selling price in the ordinary course of business less costs of reconditioning and costs that must be incurred to in order to make the sale.

Calculation of Residual Value Losses

3.57 [Residual value commitment less Net realizable value (NRV) of used products on the date of the return (as defined above)] X [Expected future rate of return]

3.58 Calculation of NRV and the residual value commitment should, if possible, be made on a “product by product” basis. However, if it is not possible , then the group of products sold with residual value commitments must be divided in subgroups of products with similar characteristics (similar model, market, customer, type of use etc.) and the calculation of NRV and residual value commitments should be made for each subgroup separately. The impact of the expected future rate of return should generally be posted on a collective basis for each subgroup.

Recognition of Residual Value Losses

3.59 Residual value losses should be recognized when they are probable and can be measured reliably.

3.60 Residual value losses for some products (or a group of products) should not be set off with the residual value gain of other products (or a group of products). In case of trade-back contracts, it is not permissible to offset the calculated residual value losses with the expected future gross income on new product sales.

Recognition of Residual Value Losses at the Time of the Initial Sale

3.61 If at the time of the initial sales transaction, the Company granted the customer a residual commitment which is higher than the NRV of the used product at that time, this residual value loss should be reported as a reduction in the gross income of the transaction.

3.62 While applying the "operating lease model", such a residual value loss will result in a higher periodical depreciation during the contract period, as explained in the box given below:

Additional residual value losses under the operating lease model (All amounts in Rs.)

Assumptions:

Same assumptions as in the above 'Illustration of operating lease', with the difference that at the end of the first year, an updated estimate indicates that the net realizable value of the used product after three years will amount to 2150, i.e. 450 lower than the initially estimated amount.

Price	5,000 (fully paid at sale)
Product cost	4,250
Residual value commitment (buy-back value)	2,750 (after three years)

Initially estimated net realizable value	2,600 (after three years)
Estimated net realizable value at end of first year	2,150 (after three years)
Price ultimately realized on sale of used product	2,150

Statement of profit and loss	**At Sale**	**First Year**	**Second Year**	**Third Year**	**Used Vehicle Sale*****
Leasing Income	-	750	750	750	-
Sale of used product	-	-	-	-	2,150
Leasing income/ Net Sales	-	750	750	750	2,150
Depreciation (= SCS)	-	(550)	(550)	(550)	-
Additional Depreciation (= Variance)*	-	-	(200)	(200)	-
Write-down (= Variance)*	-	(50)	-	-	-
Cost of used product	-	-	-	-	(2,150)
Gross Income	-	150	-	-	-
Balance Sheet:**					

Assets:					
Assets under operating lease	4,250	(600)	(750)	(2,900)	-
Inventory	(4,250)	-	-	2,150	(2,150)
Cash	5,000	-	-	(2,750)	2,150
Liabilities:					
Shareholders' equity	-	150	-	-	-
Deferred Leasing income	2,250	(750)	(750)	(750)	-
Residual value liability	2,750	-	-	(2,750)	-

* Revaluation of residual value provision

** The amounts reflect the change of the balance sheet values during different periods.

*** Assuming that the customer utilizes the buy-back agreement.

Comment

The initially calculated residual value loss of 150 (2600-2750) is accounted for as depreciation allocated over the commitment period. Out of the additional residual value loss of 450 (2150-2600), because the initially estimated net realizable value was optimistic, a write-down of 50 needs to be accounted for immediately at the end of the first year as this part of the residual value loss is not covered by unrecognized gross profit on the transaction.

The remaining part of the additional residual value loss is

accounted for as additional depreciation allocated over the remaining commitment period, i.e. 200 per year during the second and third year.

Improvement of Market Conditions

3.63 Where the residual value losses recognized during an earlier period are no longer probable due to improvements in the market conditions, the depreciation, write-downs or provisions made for these losses should be reversed. While applying the "operating lease model", reversal of depreciation should be allocated over the remaining contract period.

Expected future residual value gains should not be recognized until they are realized

Sales in Foreign Currencies

3.64 Sales denominated in foreign currencies should be translated using the historical exchange rate on the date of the transaction (as stated in AS – 11). The auditor needs to verify that exchange fluctuation on export debtors has been appropriately accounted.

3.65 If the sale is hedged in accordance with the accounting principles stated in AS 30, and if the criteria for cash flow hedging are satisfied, the effective portion of the gain or loss will initially be recognized in equity and subsequently recycled to the statement of profit and loss in accordance with AS 30. The ineffective portion of the gain or loss will directly be taken to the statement of profit and loss.

3.66 The export sales are eligible for the exports benefits in the form of DEPB licenses / Duty Draw back. The Company should recognize the export incentives at the time of booking of sales provided it is reasonable to expect ultimate collection. In case there is any doubt for the recovery of these incentives, these should be provided for. Also see Chapter 8.

Revenue from Financing/Leasing

Interest Income on Installment Credit Granted to Dealers or Ultimate Customers

3.67 Interest income on installment is recognized on an accrual basis using the effective interest method.

Interest Income on Finance Leases

3.68 All the significant risks and rewards of ownership are transferred by the lessor to the lessee under a finance lease. Lease rentals receivable from the lessee are separated into repayments of principal amount and interest income.

3.69 The income allocation is based on a pattern reflecting a constant rate of return on the lessor's outstanding net investment.

3.70 The difference between the total rent received and the interest, as computed above, should reduce the net investment in order to reflect the outstanding amount receivable.

Rental Income from Operating Leases

3.71 Rental income from an operating lease should be recognized on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern of the earning process of the lease.

Sales Return

3.72 For some companies, sales return forms a major part of the transactions. The sales returns may be due to the following reasons:

1. Technical default.
2. Delivery of goods to dealers without valid purchase order.

3. Mistake in delivery documents, like invoice or challans.

3.73 While checking the revenue, the auditors should ensure that sales return of goods subsequent to the reporting dates pertaining to the reasons 1 and 2 above should be adjusted from the revenue. However, with respect to the reason 3, no adjustment is required to be made.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material Misstatement

3.74 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering “what can go wrong” for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

3.75 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor’s cumulative knowledge of the entity.

3.76 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

3.77 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity’s controls, including control activities, relevant to that risk.

3.78 Hence, these audit procedures will vary according to the given situation.

Sales

Material Classes of Transactions, Account Balances and Disclosures	Assertions		Audit Procedures
Sales		**A**	**System update**
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	**Review of sales contracts** Review sales contracts/agreements including side agreements to identify the terms of the sales and summarize the important terms and conditions of these contracts.
		C	**Recording accuracy**
	Accuracy, Completeness	1	Obtain/prepare a schedule of sales. Test the total and reconciliation of the total to: • Debtors ledger containing bill wise detail of each party. • Profit & Loss Account. • Compare and reconcile the sale quantity and value with the details filed by the Company in its statutory return such as Excise/VAT etc. • Compare the list of

			customers with the list of dealers/customers as per the Marketing system/other sources to ensure the existence of the customer. Also send periodical confirmation of balances to major customers to ensure existence of customers and the terms of sales. • Obtain a list of all price revisions made during the year from the sales team of the Company and check whether those have been considered appropriately in the books of account.
		D	**Review of balances**
	Occurrence	1	Review the pattern of sales by month for the year to latest practicable date with corresponding pattern shown in the budget and in the previous years. Also compare the growth trend with the industry trend. Investigate any significant variations in pattern, particularly:
	Cut Off		• variations in the periods before and after the year end which may indicate a deliberate acceleration of invoicing and revenue recognition.
	Completeness		• reduced sales in the months which may indicate omissions of

			sales.
	Accuracy, Classification	2	Review sales accounts with significant debit balances and check for any misstatements. Investigate for any unusual entries if they pertain prior to year-end.
	Accuracy, Classification	3	Investigate any journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements at the year end and test the appropriateness of such entries.
		E	**Test propriety of revenue recognition policies and procedures – Sales**
	Accuracy, Classification	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on sales balances.
	Accuracy, Classification	2	Determine that the accounting policies and methods for revenue recognition are appropriate and are applied consistently.
	Occurrence		• Verify that delivery has occurred or services have been rendered.
	Accuracy, Occurrence		• Delivery generally is not considered to have occurred unless the customer has taken title

			and assumed the risks and rewards of ownership of the products specified in the customer's purchase order or sales agreement. After the delivery of a product or performance of a service, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs.
	Accuracy		• Collectability of the revenue is reasonably assured.
	Completeness, Classification, Occurrence		• If any of the following are excluded from recorded revenues, determine that the exclusion is appropriate in relation to the economic substance of the transactions:
			* Consignment sales.
			* Sales with recourse.
			* Other deliveries of goods or performances of services without sales being recorded.
			* Bulk sales orders with multiple shipping dates.
			* Deferred revenues.
			* Installment sales.
	Occurrence, Accuracy, Classification	3	Make a selection of revenues recorded in the general ledger and verify that revenue

			was appropriately recognized.
	Classification, Occurrence	4	Design and perform appropriate procedures to understand and test significant revenue streams that are not converted to cash in a relatively short period of time (e.g. 60 to 90 days). Revenue streams not converted to cash in a relatively short period of item may be generated on the basis of contractual obligations and/or may be contingent on particular events occurring. In designing and performing procedures, consider matters related to revenue recognition such as the following:
			• The nature of the specific transactions.
			• Who bears the risk in the transaction.
			• Payment terms.
			• The nature of any related contingencies.
	Classification	5	Whether an entity should report revenue based on (a) the gross amount billed to a customer because it has earned revenue from the sale of the goods or services or (b) the net amount retained (that is, the amount billed to the customer less the amount paid to a supplier) because it has earned a commission or fee. In assessing whether revenue should be reported

			gross with separate display of cost of sales to arrive at gross profit or on a net basis, consider whether the entity:
			• Acts as a principal in the transaction.
			• Takes title to the products.
			• Has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns, and
			• Acts as an agent or broker (including performing services, in substance, as an agent or broker) with compensation on a commission or fee basis.
		6	Additional audit procedures to establish delivery: • Test the proof of delivery of vehicles to the customers/proof of handing over the vehicles to the carrier depending on the terms of sale. • Test the shipping/customs clearance documents and compare the same with the timing of revenue recognition in the books of account. • Where the documents available with the Company do not provide sufficient evidence of transfer of risks and rewards to recognize sales, obtain

			confirmations from customers confirming their acceptance of the risks and rewards.
		7	Evaluate results of the tests.
		F	**Test sales balances**
	Occurrence, Completeness, Accuracy	1	Perform substantive analytical procedures to test sales balances. Consider developing an expectation of sales during the year:
			• Historical and current year trends in sales and sales returns.
			• Historical and current year trends in cost of sales and gross margins.
			• Historical and current year shipments (or hours of service) and pricing.
			• Sales to largest customers.
			• Industry statistics.
			• Changes in the business in the current year affecting the pricing or sales mix.
	Classification, Occurrence, Completeness	2	Consider disaggregating the data used to build the expectations and the recorded sales balances at a level of detail sufficient to enable obtaining the desired level of assurance based on a comparison of the amounts. Consider the following means of disaggregation:
			• By period.
			• By account, product line,

			or both.
			• By division or location.
	Accuracy	3	Determine that the data used to make an independent estimate is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Accuracy	4	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	-	5	Determine the threshold – the amount that represents the maximum needed to identify a significant difference between the expectation and the recorded sales amounts that is acceptable without further investigation.
	-	6	Compare the expectation to the recorded balance and identify any differences. For any difference that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
	Accuracy,	7	We also consider

	Completeness , Occurrence		investigating the following:
			• Any unusual pattern in the differences.
			• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud.
		8	Determine whether there are unusual relationships involving year-end revenue and income. Consider whether the following conditions exist:
	Cut Off		• Uncharacteristically large amounts of income being reported in the last one or two weeks of the reporting period from unusual transactions.
	Classification		• Income that is inconsistent with trends in cash flow from operations.
	Classification	9	Perform tests of details of sales transactions. As debits to cost of sales are recorded concurrently with credits to sales, make a selection of debits to cost of sales:
	Occurrence		• Trace the item to a sales

			invoice and final sales contract, if applicable.
	Accuracy		• Agree the sales invoice prices to a price list.
	Accuracy		• Verify additions and extensions on the invoice.
	Cut Off		• Review shipping records or evidence of service performance to determine that the sale was recorded in the correct period, based on the terms of the sales agreement.
	Completeness		• Trace the sales invoice amount to a sales journal.
	Completeness		• Trace the sales journal total to the general ledger.
	Occurrence, Accuracy	10	Make a selection of items from other independent source documents corresponding to revenue transactions (e.g. shipping records):
	Completeness		• Test the numerical sequence of the source documents, if numerically controlled, or otherwise test the completeness of the records.
	Completeness		• Trace the item to a sales invoice and final sales contract, if applicable.
	Accuracy		• Agree the sales invoice prices to a price list.

	Accuracy		• Verify additions and extensions on the invoice.
	Cut Off	11	Review shipping records or evidence of service performance to determine that the sale was recorded in the contract period, based on the terms of the sales agreement:
	Completeness		• Trace the sales invoice amount to a sales journal.
	Completeness		• Trace the sales journal to the general ledger.
		12	Evaluate results of the tests.
		G	**Test sales returns**
	Completeness, Accuracy, Cut Off, Occurrence	1	Make a selection of recorded sales returns:
			• Trace selected sales returns to credit notes. Trace credit notes to receiving documents and original sales invoices, and to customer correspondence, if any. Ensure that credit is given for proper amount and returned inventory is properly valued. Determine that the credit notes were recorded in the correct period.
		2	Evaluate results of the tests.
		H	**Test early cut-off of sales**
	Cut Off	1	Make a selection of records representing shipments or

			services that occurred in the **five (5)** days period prior to year end:
			• Trace selected shipping records to sales invoices and final sales contracts, if applicable. Determine that sales were recorded in the correct period.
	Cut Off	2	Make a selection of recorded sales invoices in the **five (5)** days period after year end:
			• Trace selected sales invoices to shipping records. Determine that the transactions were recorded in the correct period.
		3	Evaluate results of the tests.
		I	**Test late cut-off of credit notes**
	Cut Off	1	Make of selection of customer returns in the **fifteen (15)** days period after year end:
			• Determine that the credit notes (debits to sales or sales returns accounts) were recorded in the correct period.
	Cut Off	2	Make a selection of recorded credit notes in the **five (5)** days period prior to year end:
			• Trace the credit notes to receiving records and determine that they were recorded in the correct period. Ensure that credit is given for proper amount and returned

			inventory is properly valued.
	Cut Off, Accuracy	3	Make a selection of miscellaneous debits to sales recorded in the **fifteen (15)** days period prior to year end:
			• Trace the debits to supporting documents and determine that they were recorded in the correct period.
		4	Evaluate results of the tests.
		J	**Roll forward test for sales tested prior to year end**
	-	1	This test is to be performed where we have performed detail testing of sales on an interim date. The following procedures have to be performed for the period from the interim date to the balance sheet date.
	Completeness, Occurrence, Accuracy	2	Perform substantive analytical procedures to test the sales balance at the year-end. Consider using the following data, as applicable, to develop an expectation of the receivables balance at the year-end:
			• Monthly amounts of sales and sales returns in the intervening period from the interim testing date to the balance sheet date compared to such monthly amounts in prior years and in the current year prior to the interim testing date.

			• Monthly amounts of costs of sales and gross margins in the intervening period from the interim testing date to the balance sheet date compared to such monthly amounts in prior years and in the current year prior to the interim testing date.
			• Monthly amounts to historical and current year shipments (or hours of service) and pricing from the interim testing date to the balance sheet date compared to such monthly amounts in prior years and in the current year prior to the interim testing date.
	-	3	Determine the threshold – the amount that represents the maximum needed to identify a significant difference between the expectation and the recorded year end sales balance that is acceptable without further investigation.
	-	4	Compare the expectation to the recorded balance and identify any differences. For any difference that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and

			examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		5	We also consider investigating the following:
	Accuracy, Completeness, Classification		• Any unusual pattern in the differences.
			• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud.
		6	Test transactions during the intervening period between the interim testing date and year end:
	Completeness		• Obtain a reconciliation of the sales balance to the year-end balance and agree sales total to sales journals.
	Accuracy, Occurrence		• Examine supporting documents to verify other significant entries.

		7	Make a selection of entries in sales journal in the intervening period between the interim testing date and year-end:
	Accuracy		• Trace the selected entries to sales invoices and shipping records.
	Accuracy		• Agree the sales invoice prices to a price list.
	Accuracy		• Verify additions and extensions on the invoices.
	Cut Off		• Determine that the sales were recorded in the correct period.
		8	Evaluate results of the tests.
		K	**Test amortization of deferred income balances**
	Classification, Accuracy	1	For selected deferred income balances, obtain an understanding of the nature of the deferred income, determine that the period of amortization is appropriate and test the entity's calculation of the release into income.
		L	**Test foreign currency sales**
	Completeness, Occurrence	1	Inquire and consider other available evidence, if any, to identify foreign customers

			with whom sales transactions were in foreign currency.
	Accuracy	2	Agree the closing rate(s) used to published records and test the translation calculation.
	Classification, Accuracy	3	Determine the impact of foreign currency hedging contracts, if any, on the recorded balance of foreign currency receivables.
	Accuracy, Classification	4	Trace currency translation adjustments to the general ledger.
		M	**Test presentation of sales**
	Classification, Understand-ability, Valuation, Accuracy	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on receivables.
	Completeness **Classification & Understand-ability** **Classification & Understand-ability** **Classification & Understand-ability** **Classification**	2	Determine that amounts presented as sales and receivables are properly recorded, classified and/or disclosed as required by the Revised Schedule VI of the Companies Act: • Total turnover, that is, the aggregate amount for which sales are affected by the entity. • Revenue should be shown under the following heads: • sale of products;

	& Understand-ability, Accuracy &Valuation, Classification & Understand-ability		• sale of services; • other operating revenues; Less: • Excise duty. • Excise duty should be shown as deduction from turnover. Excise duty related to increase/decrease in inventory should be shown in profit and loss account. • In case of companies rendering or supplying services, the gross income derived from services rendered or supplied. • Earnings in foreign exchange from export of goods calculated on F.O.B. basis. • Check that scrap/waste sales are disclosed under miscellaneous income and not considered as part of sales.
	Completeness	3	Obtain from the management the information identifying all known related parties, account balances and transactions, and test the information for completeness:
	Occurrence and rights & obligations		• Review the accounts of parties mentioned in section 301 of the

			Companies Act, 1956 in the sales ledger and check if sales recorded to such parties aggregate during the year to Rs.500,000 or more.
	Accuracy & Valuation		• For such parties, make a selection of sales and test reasonableness by agreeing sales prices to similar sales from other parties and to available price lists.
		4	Determine that the amounts related to the items listed below are properly recorded, classified, and/or disclosed:
	Classification & Understand-ability, Accuracy & Valuation		• Sales to related parties.
	Classification & Understand-ability, Accuracy & Valuation		• Sales to consolidated companies, with particular attention to inter-entity profit elimination.
	Classification & Understand-ability, Accuracy & Valuation	5	• Non-trade sales. Review the sale agreements to ensure that the price does not include any other component such as extended warranty fees etc., in which case such portion of the price should be recognized appropriately and disclosed separately and not as part of sales.

		N	Conclusion
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.
	-	2	Consider including the following when documenting the conclusion: • A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. • The relevant potential errors and control objectives for each account balance or disclosure being tested. • The substantive procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors. • The results of substantive tests, including misstatements identified, and how such results support the conclusion on the

			potential errors for each account balance or disclosure. • The tests of controls we performed or a cross reference to where the tests of controls performed are documented. • The results of the tests of controls, including deficiencies identified, and how such results support the conclusion as to whether we have obtained control reliance for the potential errors for each account balance or disclosure.

Chapter 4
Fixed Assets

4.1 In the automotive industry, fixed assets mainly comprise of land, buildings, plant and machinery, tools, moulds, computers, furniture and fixtures, vehicles, assets taken under finance lease and intangible assets such as technical know how, software etc. Assets such as tools, moulds and technical know-how are usually specific to a particular product model and are peculiar to this industry.

Classes of Assets

4.2

A. Buildings: Buildings consist of facilities or constructions and service units such as heating installations, tunnels and tanks for heating fuel.

B. Plant and machinery: The items under plant and machinery are generally categorized as follows:

- Assembly Lines.
- Paint Shop.
- Press Shop.
- General Engineering.

Plant and machinery constitute a major part of the asset block of an automotive Company. They are mostly high-value items which can be either manufactured specifically to the Company's need or purchased by the Company. The asset register is generally maintained according to the product models as it helps in the impairment analysis. Other assets which are not specific to the automobile models are maintained by the Company as a whole.

C. Tools: Tools represent the manufacturing aids, such as dyes, fixtures, and machine heads, which are attached to or are used in conjunction with fixed manufacturing facilities. Tools may be type-bound or general. A type-bound tool is specific to a particular product or product line. They are designed or acquired for the production of new products or models, and their utility generally ceases with the discontinuation or modification of such products or models. When the product is phased out, the tool specific to that product is also scrapped. Therefore, it is imperative that the records for various tools, dyes, jigs and fixtures are kept model-wise so that they are depreciated correctly or impaired if the corresponding model is impaired. Tools can be readily relocated.

D. Moulds: In addition to moulds directly used by the Company, the Company also owns/finances moulds in the case of out-sourced products. Such moulds though owned/financed by the Company are usually kept in the custody of an outside supplier. These moulds are either purchased or manufactured by the Company and are shipped to the supplier. The supplier can also purchase or manufacture these moulds. The supplier (first tier supplier) may also further ship these moulds to its sub-contractor (second tier supplier).

E. Intangible assets: This mainly includes the technical know-how expenditure and has been discussed in the succeeding pages.

Moulds

4.3 The accounting of moulds would differ according to the arrangement related to the custody of the moulds with the supplier. Very often, the Company finances the moulds for the suppliers. To check the accuracy, the auditor should ensure that the accounting has been done as per the agreement.

Illustrations

1) *Moulds manufactured and owned by the supplier and cost of production charged to the Company on cost per piece basis:*

Background

X Auto Limited, a manufacturer of car model – Alpha, regularly purchases components from its Vendor Y. To manufacture these components, Y has manufactured/purchased certain moulds according to the specifications given by X. These moulds are owned by Y and are used only for manufacturing the components of Alpha for X. The price arrangement between X and Y is such that the cost of production of these moulds would be recovered from X on cost per piece basis.

Solution

Y should capitalize these moulds and depreciate them over their useful lives/per piece basis on the basis of total estimated production of components. X should treat the proportionate cost of moulds included in the rate charged per piece by Y as a part of the purchase cost of the component.

The Company should keep the quantitative details of such moulds as they are developed by the suppliers on behalf of the Company.

Audit procedures

- The terms of the agreement between the Company and the supplier should be reviewed thoroughly by the auditor in order to check as to who bears the significant risks and rewards of the ownership of the moulds and that the agreement does not contain any financing or leasing element related to the moulds developed by the supplier.
- The rates charged per piece should be reviewed or re-calculated and it should be ensured that the Company has proper controls in place related to its costing system.

2) *Moulds manufactured and owned by the supplier and cost of production charged from the Company on cost per piece basis with a commitment to purchase a specified minimum quantity:*

Background

Using the same facts as given in Illustration 1, X has a commitment to purchase minimum 10,000 items every year and the cost per piece of the mould is Rs. 10 per unit. In the year 20XX, X purchased only 7,000 items.

Solution

In case the normal off-take is > or = 10,000 items, then in the year in which the off-take in only 7000 items, mould cost of Rs. 10 each per piece would be treated as a part of the purchase cost of components and should be expensed off when the components are consumed.

Balance Rs. 30,000 (cost of the remaining 3,000 items at Rs. 10 per piece) should be expensed off immediately.

In case where the normal off-take is 7,000 units, the whole amount of Rs. 100,000 should be inventorized and should be expensed off when components are consumed.

Audit procedures

In addition to the procedures listed in Illustration 1, the auditor should, at each cut-off date ensure that the provision has been made adequately for the committed amount in the books of account.

Based on the planned off take establish the normal cost which should get inventorized or charged off.

3) *Moulds manufactured and owned by the Company and shipped to the supplier:*

Very often an automotive Company, in order to maintain strict quality procedures, manufactures moulds and then sends them to the supplier.

Background

X Auto Limited, a manufacturer of car model – Alpha, regularly purchases components from its Vendor Y. To manufacture these components, X has manufactured/purchased certain moulds and has given them to Y.

Solution

X should capitalize these moulds and depreciate them over their useful lives/per piece basis on the basis of total estimated production of components.

Y should maintain the records of such moulds as it holds them on behalf of X.

X should also maintain the records of such moulds kept by Y on its behalf.

Audit procedures

- The auditor should ensure that the moulds are valued appropriately and recorded in the fixed assets register correctly.
- Physical verification of these moulds should be carried out at regular intervals and confirmations should be obtained from the supplier regarding the moulds present in his premises.
- Depreciation should be charged off on the basis of the useful lives of these moulds/per piece basis.

4) *Moulds manufactured by the supplier and financed by the Company:*

Background

X Auto Limited, a manufacturer of car model – Alpha, regularly purchases components from its Vendor Y. To manufacture these components, Y has manufactured/purchased certain moulds according to the specifications given by X. Further, X has financed the cost of such moulds and charges interest @ 9% p.a.

These moulds are owned by Y and are used only for manufacturing the components of Alpha for X. The price arrangement between X and Y is such that the cost of these moulds would be recovered from X on cost per piece basis.

Solution

Y should capitalize these moulds and depreciate them over their useful lives/per piece basis on the basis of total estimated production of components.

The finance given to Y by X should be classified as a loan and interest should be accounted for as an income on accrual basis in the books of X.

X should treat the proportionate cost of moulds included in the rate charged per piece by Y as a part of the purchase cost of the component and should expense off the same when the component is consumed.

Audit procedures

- The auditor should evaluate whether the financing agreement is covered under the purview of AS 19 – Leases and the accounting should be done accordingly.
- The auditor should review the terms of the contract to check if the loan given by the Company to the supplier is backed by a deed of hypothecation.

- The auditor should check whether the loan given is recoverable or not. If not, it is in the nature of an advance i.e. given as an adjustment to the price of the mould, in which case it should be amortized in proportion to the pieces received from the vendor.
- The auditor should ensure that the loan is appropriately classified as secured or unsecured.

5) *Moulds manufactured by the Company and subsequently sold to the supplier:*

In this case, revenue should be recognized when these moulds are sold by the Company to the supplier as per the criteria stated in AS 9 – Revenue Recognition.

Background

A Auto Limited, manufactures certain moulds for selling them to its component supplier, B. B regularly purchases these moulds from A. The risks and rewards are transferred to B on its purchase.

Solution

A should treat these moulds as inventory since they are produced for sale in the ordinary course of business. Revenue should be recognized once these moulds are sold.

B should treat these moulds as the cost of purchase of the moulds and should capitalize them depending on their nature.

Audit procedures

- The auditor should ensure that the revenue is recognized on the sale of these moulds in accordance with AS 9 – Revenue Recognition.
- The auditor should also check that, at each reporting date, such moulds are not capitalized but are treated as inventory.

6) *The sales agreement provides for the partial recovery of the cost of moulds from the vendors:*

Here, the unrecovered portion of the cost should be depreciated.

Background

A Auto Limited, regularly manufacture moulds for its vendor B. The price arrangement between A and B is such that a portion of the cost of these moulds is charged directly to B. These moulds are owned by A.

Solution

A should capitalize the portion of the mould cost which is not recovered from B and depreciate it over the useful life/per piece basis on the basis of total estimated production of components.

7) *Accounting for the cost of moulds manufactured by the vendor of the components:*

Background

A Auto Limited, regularly purchases moulds used in its manufacturing process from its vendors and as per the contract with its vendors, A is owner of these moulds on "as is where is" basis. These vendors regularly submit the status report of these moulds and transfer them to A once the moulds are completed.

Solution

At the end of each period, A should calculate the amount of these moulds, treat them as Capital work-in-progress (CWIP) and provide for the corresponding liabilities. Assuming that there are only two moulds, their status as at the period end is as follows –

Particulars	Total cost of moulds Rs.	Percentage completed at the period end	CWIP Rs.
Mould K	100,000	20%	20,000
Mould L	200,000	40%	80,000

Hence, the mould cost is accounted as CWIP and a corresponding liability of Rs.100,000 is created in the books of A. Once the manufacture of the mould is completed, its cost is capitalized.

Other Concepts Related to Tools and Moulds

Control Issues Specific to Tools

4.4 It is difficult to track some of the tools as individual assets. This may be due to the tools being too small to mark, highly mobile or in the custody of outside vendors. However, if possible and practical, a system of control over the tools should be maintained by the management so that (1) acquisitions and disposals of tools are executed in accordance with management's authority and (2) accountability over the tools is maintained.

The auditor should review such system to ensure proper recording of the tools in the financial records.

4.5 A high percentage of special tools/moulds owned by the Company could be in the custody of the suppliers(both outside and allied).The management should obtain confirmation letters from such suppliers regarding the possession of tools on regular intervals. Confirmation letters are an important mechanism in ensuring control over special tools. Once the production is over, a vendor may still be required to retain the tool in order to create replacement parts. In this case, it is recommended that an annual confirmation is taken from the supplier. The confirmation letter serves to confirm the physical

location of the tool which may be required for certain tax or other governmental reporting.

4.6 Confirmation letters may include the following:

i) Description of tools or any other information which will assist the Company in identifying the special tools/moulds.

ii) Request for confirmation that the supplier still has the special tools.

iii) Request for explanation if the supplier does not have the special tools.

iv) Request for the confirmation of the physical location of the tools.

v) Request for the status of the tools (active, idle, scrapped etc.).

4.7 The management should reconcile the differences, if any, between the confirmation letters received and the book records. If required, an adjustment entry should be passed by the management in the financial records. The auditor should review such confirmations and ensure that the financial records are true and fair.

Depreciation of Tools

4.8 Tool costs may be depreciated over the number of years of their useful lives or a number of production units. Depreciation over a number of production units generally results in a more constant charge to each unit, particularly when production extends over a number of years and annual production volume varies. Depreciation over a period of years may achieve substantially the same result when the life of the tool or product is relatively short and when the production volume is reasonably constant. The method which assigns the same depreciation charge to each unit produced should be considered. The management should regularly review the useful lives of assets at the end of each period/year.

4.9 If the tools are specific to a particular model of the product, they are generally used during the useful life of the product manufactured and their utility ceases when the manufacturing process is over. The general policy is to depreciate the cost of such tools over the useful life of the product and they are impaired when the life of the product is over. Management is responsible for determining the useful lives of a product for depreciation purposes. Depreciation should begin as soon as the production starts.

4.10 The auditor should verify the classification of the fixed assets to ensure that the tools are depreciated/impaired correctly. The management should maintain adequate records to substantiate the costs accumulated with regard to the specific tools. The records should be in conformity with the general ledger. The auditor may rely on the technical personnel certificate in case of a new model of the vehicle and should corroborate with the past experience of other models.

Intangible Assets - Technical Know-how Expenditure

4.11 Companies usually pay one time technical know-how fee i.e. Intellectual Property Rights (IPR) fee to the owner of IPRs for a new model of the vehicle launched in India. Usually the owner of IPR is a group Company, a parent Company or an outside party such as a Joint Venture.

4.12 The amount paid as IPR fees usually meets the conditions of an intangible asset as stated in AS 26 – Intangible Assets. It should be noted that the research costs embedded in the agreements related to the technical know-how fees should be expensed off. However, when the research costs are incurred for the development purposes, they should be capitalized if all the conditions as per AS 26 are met.

4.13 While some development activities may result in an asset with physical substance, the physical element is secondary to its intangible component i.e. the knowledge embodied in it. Where development relates to an intangible asset, the cost of the assets

can be capitalized only if it is considered probable that the future economic benefits attributable to the asset will flow to the enterprise and the costs can be measured reliably. Consequently, the degree of certainty about the success of the product being launched is also a key element.

Illustration

Background

X Auto Limited, has paid technical know how fee of USD 100 million for the IPR of newly launched car model Alpha held by Z Auto Limited.

The issue faced by X Auto Limited is whether X should capitalize the same as an intangible asset or expense it off.

Solution

X should capitalize USD 100 million as intangible assets if, and only if, all the conditions given in AS 26 are fulfilled, which include the following:

(a) the technical feasibility of completing the product for which know-how is sought for so that it will be available for use or sale;

(b) X's intention to complete the intangible asset and use or sell it: Following should be considered under this:

i) X's ability to use or sell the intangible asset;

ii) Whether the intangible asset will generate the probable future economic benefits. Among other things, X should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

iii) the availability of adequate technical, financial and

other resources to complete the development and to use or sell the intangible asset; and

(c) X's ability to reliably measure the expenditure attributable to the intangible asset during its development.

If the above conditions are not fulfilled, the fees should be expensed off immediately.

Audit procedures

- The auditor should ensure that all the requirements of AS 26 have been complied with as stated above.
- The auditor should obtain a copy of the agreements and ensure that the amount paid is not for the research activities, training activities, marketing activities but are towards the development of the products.
- It should be ensured that the Company has all the requisite approvals and that the Company has control over usage of the intangible asset.
- The auditor should check that the intangible asset is correctly amortized.

Depreciation of Fixed Assets

4.14 Most automotive companies depreciate the fixed assets over their estimated useful life. A Company should follow Schedule XIV of the Companies Act, 1956 for depreciation. If the estimated useful life of an asset is shorter than the useful life determined using the Schedule XIV rate, depreciation on the shorter useful life should be provided and a note explaining the depreciation policy should be given in the financials of the Company.

4.15 The auditor should ensure that the rate adopted by the Company for depreciation is a correct measure of the wearing out,

consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes.

Other Procedures for Auditing Fixed Assets

4.16 While conducting the audit of fixed assets, an auditor is primarily concerned with testing the recording, cut-off procedures, existence and valuation of fixed assets.

4.17 The auditor has to comment on the following given under the Companies (Auditor's Report) Order, 2003 (CARO) issued by the Central Government in terms of Section 227 (4A) of the Companies Act, 1956 –

- Whether the Company is maintaining proper records showing all the particulars, including quantitative details and location of the fixed assets.
- Whether these assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were identified during such verification and if so, whether they have been properly dealt with in the books of accounts.
- If a substantial part of the fixed assets have been disposed of during the year, whether it has affected the going concern of the Company.

4.18 The auditor has also to comment on whether there is an adequate internal procedure commensurate with the size of the Company and nature of its business, for the purchase of fixed assets and whether there is a continuing failure to correct major weakness in internal controls.

Internal Control System for Fixed Assets

4.19 Management should monitor the compliance with all significant policies concerning the fixed assets. Exceptions to the fixed assets policies and procedures should be noted and raised to the appropriate levels within the Company and resolved in a

timely manner. Internal control system for fixed assets will involve the following checks and inquiries:

Acquisition of Fixed Assets

4.20 To ensure that the fixed assets were actually acquired by the Company and recorded correctly, changes in the fixed assets register and/or in the master file should be made on the basis of authorized source documents and approved by the management or other authorized personnel who are not involved in recording the changes. Asset acquisitions and related financing agreements should be reviewed by management (including consideration of the capital expenditure budget) before being authorized. Requests to change the fixed assets register and/or master file data should be submitted in a proper form and processed timely so that the fixed asset acquisitions are recorded in the appropriate period. The fixed assets register and/or master file data should be periodically reviewed by the management for accuracy and reconciled to the corresponding general ledger accounts. Any reconciling items should be identified and addressed in a timely manner.

Depreciation of Fixed Assets

4.21 Depreciation rates and methods of calculation should be reviewed periodically to ensure that the depreciation charges are reasonable and in accordance with generally accepted accounting principles. Where manufacturing is done in shifts, the depreciation rates for shift operations should be applied. The auditor should verify that the calculations of the extra depreciation for double shift working and for triple shift working are made separately in the proportion which the number of days for which the concern worked double shift or triple shift, as the case may be, bears to the normal number of working days during the year.

4.22 Standard programmed algorithms should be used to calculate the depreciation charge accurately. Depreciation charges should be reviewed by the management, including the consideration of recording such charges in the appropriate accounting period.

Disposal of Fixed Assets

4.23 To ensure that the fixed assets disposed represent actual disposals made, changes in the fixed assets register and/or in the master file should be made on the basis of authorized source documents and approved by the management or other authorized personnel who are not involved in recording the changes. Requests to change the fixed assets register and/or master file data should be submitted in a proper form and processed timely so that the fixed asset disposals are recorded in the appropriate period. The fixed assets register and/or master file data should be periodically reviewed by the management for accuracy and reconciled to the corresponding general ledger accounts. Any reconciling items should be identified and addressed in a timely manner.

Managing Fixed Assets

4.24 To ensure that the fixed assets records are accurately maintained, asset maintenance schedules should be prepared, updated, and monitored by the management at regular intervals. Activity per the asset maintenance schedule should be reconciled to the asset maintenance history register regularly.

4.25 Fixed assets should be located in an appropriate and secured area where access is restricted to the authorized personnel only. There should be proper security arrangements at the premises. Appropriate safety measures such as fire alarm systems, burglar alarms should be in place.

4.26 Adequate insurance cover should be obtained for the fixed assets. Regular annual maintenance contracts should be entered into for their maintenance.

4.27 Management should physically verify the fixed assets and reconcile the same to the fixed assets register. The interval at which such verification is to be conducted should also be determined by the management. Discrepancies, if any, noted during the physical verification should be appropriately dealt with.

4.28 It is essential to ensure that the financial information is appropriately presented, and all information necessary for the fair presentation and compliance with the professional standards or legal requirements is disclosed. To achieve this objective, fixed assets staff should be appropriately trained. They should be able to classify the assets properly, identify a finance lease or an operating lease etc.

Maintaining a Fixed Assets Register and/or a Master File

4.29 Only authorized personnel should be allowed to access the master tables in the fixed assets register. Any changes in the fixed assets register and/or the master file should be made on the basis of authorized source documents to ensure that they were recorded accurately and in time. The fixed assets register and/or the master file data should be periodically reviewed by the management for accuracy and reconciled to the corresponding general ledger accounts. Any reconciling items identified should be addressed in a timely manner.

Assets Transferred

4.30 Sometimes, fixed assets like furniture, office equipments, etc. are transferred from one office to another. The auditor should examine whether the accumulated depreciation in respect of such assets is also transferred. It may be noted that the consolidated accounts of the Company would not be affected by such transfers. However, the expenses which are related to the capital items but are in the nature of operating expense e.g. expenses incurred in the course of removing existing items of plant and equipment or rearranging plant layouts should be expensed off as and when incurred.

Assets Lying with Third Parties

4.31 Sometimes, fixed assets like moulds and tools are often lying with the subcontractors/ suppliers from whom the Company purchases components. The Company should maintain a list of all such items separately and also have a program for periodical physical verification of such items. The

Company should also have procedure of obtaining periodic confirmation from the sub- contractors/ suppliers stating the location / description/ quantity and the physical condition of the Company's assets held by them.

General Audit Procedures

4.32 The auditor should verify the opening balance of fixed assets with reference to the schedule of fixed assets, the ledger or the fixed assets register. The auditor should also examine whether the balances as per the fixed assets register reconcile with the ledger and the financial statements.

4.33 As per AS 10, Accounting for Fixed Assets, the cost of an item of fixed asset comprises of its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use. Trade discounts and rebates are deducted in arriving at the purchase price. Site preparation costs, initial delivery and handling costs, installation costs and professional fees are some examples of directly attributable costs. Administration and other general overhead expenses are usually excluded from the cost of fixed assets, unless they are specifically attributable to the construction project or to the acquisition of a fixed asset or bringing it to its working condition.

4.34 Substantive procedures for audit of fixed assets may include the following inquiries and verifications:

A. Acquisition of New Fixed Assets

4.35 Acquisition of new fixed assets should be verified by the auditor with reference to authorisation, quotations, vendor bills, title deeds, record of payment, etc.

B. Self-Constructed Fixed Assets/ New Projects

4.36 One common feature in automobile companies is the usage of internally manufactured vehicles for the purposes of the Company's own use. Similarly, automobile companies also capitalize vehicles for testing purposes internally.

4.37 The cost of such self- constructed fixed assets is measured at the production cost of the asset, which consists of the raw materials and consumables used, plus other costs incurred (including appropriate overheads) that are directly attributable to the production of the asset. Self-constructed fixed assets should be verified by the auditor with reference to the authorisation and documents such as contractors' bills, work order records and record of payments. The auditor should also verify that only directly attributable costs have been capitalized. Administrative and general overhead costs are not a component of the cost of the asset because they cannot be directly attributed to the acquisition of the asset or bringing the asset to its working condition.

4.38 The auditor should verify the methodology followed for identification of costs to be capitalized and perform procedures to validate the same. Further, the auditor should ensure that the Company maintains adequate records of such vehicles capitalized and the useful lives considered for depreciation of these vehicles are appropriate considering the purpose for which these are being used.

4.39 In the automotive industry, where a new vehicle line is set up or a new car/engine plant is set up i.e. where a project is under construction, it should be verified that it is shown in the financials under a separate heading, e.g., 'Project under construction'. Capital advances should be shown under the head 'Long term Loans and Advances' as per the requirements of the Revised Schedule VI.

4.40 In a new project, it is likely that the Company employees are used for more than one project and that there is an overlap between the construction and maintenance activities. These factors create ambiguity in identifying the costs of construction. The auditor should ensure that capital projects are clearly identified and appropriate controls are put in place to ensure that the right costs are charged to these projects. A time recording system may help in clearly identifying the time spent on construction activities and maintenance activities. If the Company

does not have a time recording system, the auditor should review the assumptions for allocating expenses to different projects.

4.41 The auditor should also review the capital budget prepared by the management for the fixed assets. Total costs capitalized under the project should be compared with the budget. The auditor should obtain explanations for significant variations noted.

4.42 If there is a system of creating purchase orders for every project – separate car-line wise, the auditor should ensure that all purchase orders under the project that is capitalized are closed. This will provide an assurance about completeness of the costs to be capitalized. If certain purchase orders are not closed for want of final invoices from the suppliers or contractors, it may be necessary to make capitalizations based on estimates.

C. Installation Fees

4.43 Since plant and machinery forms a large portion of the fixed assets in automobile companies, it is common for such companies to incur costs towards installation/related fees pertaining to the main plant and machinery. The auditor should identify such cases of fees by going through the purchase order/other relevant document for purchase of plant and machinery and ensure that the same are accounted for appropriately at the time of capitalization of the assets. If such fees are towards bringing the assets to the present condition and location, the same may be capitalized as part of the cost of such plant and machinery. In cases where the conditions for capitalization are not met, the same should be charged off to the profit and loss account in the appropriate period.

D. Capital work in Progress(CWIP)

4.44 The auditor should also review items under CWIP. If it includes any costs relating to a project that has been capitalized, inquiries with the management are necessary. The auditor should verify the certificate from the technical

department or engineers, which confirms that the fixed assets are available for use.

4.45 An aging analysis of items included in CWIP will highlight expenses which have not been capitalized for a considerable period. The auditor should make inquiries with the management for such delays and evaluate whether the CWIP should be tested for impairment.

4.46 The expenses under CWIP should be reviewed to determine whether any revenue items are debited under that head.

E. Revaluation

4.47 Where the plant and machinery (or any other fixed assets) are re-valued, the auditor should examine the basis of revaluation. The auditor should also examine whether the treatment of resultant revaluation surplus or deficit is in accordance with AS 10 -Accounting for Fixed Assets. The auditor should also check the impairment, if any, by applying the principles laid down in AS 28 - Impairment of Assets in such cases.

F. Exchange

4.48 An exchange of fixed assets is accounted for by reference to the fair market value of the asset given or the fair market value of the asset acquired, if that is more clearly evident. An exchange of similar fixed assets should not result in any gain/loss. Any assets acquired in such an exchange are recorded at the carrying value of the net book value of the assets given up. In all the above cases, adjustment should be made for any balancing receipt or payment of cash or other consideration.

G. Intangible Assets

4.49 Companies may carry amounts of goodwill, technical know-how fees (as explained above) and other intangible assets on their balance sheets. The depreciable amount of an intangible asset should be allocated on a systematic basis over

the best estimate of its useful life. For technical know-how fees, the amortization should be in line with the period of usage after considering other factors such as life of model and its obsolescence and abandonment. For e.g., if technical know-how is obtained for a specific product whose useful life is only 5 years, the technical know how should be also be amortized over a period of 5 years. If the production of the model is abandoned/discontinued before the expected 5 year period, then the balance carrying value needs to be written off in the period of such abandonment/ dis-continuance. The auditor should verify whether the Company has evaluated at each balance sheet date the amortization period and the amortization method. Adjustments made to the estimated life should also be verified.

4.50 In automotive companies, fixed assets may also include computer hardware and software. Computer hardware qualifies the definition of a ‘fixed asset’ as given in AS 10, “Accounting for Fixed Assets” (viz. “an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business”). Systems software that are essential for the functioning of the hardware (e.g., operating system) can be considered an integral part of the related hardware. Applications software is an intangible asset that is identified separately from the hardware and should be accounted for as per AS 26, "Intangible Assets".

4.51 The auditor should examine whether the accounting treatment of the expenditure on computer hardware and software is in consonance with their nature as described above. The expenditure on acquisition and installation of hardware (as also on any systems software considered to be an integral part of the related hardware) should be capitalized in accordance with the principles laid down in AS10, Accounting for Fixed Assets, and depreciated over the useful life of the hardware. Expenditure on applications software, whether acquired from outside or developed in-house, would be capitalized if criteria specified in AS 26, Intangible Assets are met, and amortized

over its useful life. However, in estimating the useful life of applications software, the rapid pace of changes in software as also the need for periodic modification/ upgradation of software to cater to changes in nature of transactions, information needs etc. need special consideration.

4.52 As far as expenditure during the stage of in-house development of software is concerned, the same needs to be accounted for in accordance with AS-26 Intangible Assets, according to which expenditure incurred during the research phase should not be capitalized as part of cost of intangibles. While capitalising the development phase expenditure, due consideration should be given to the requirements of the said Standard. Hardware and software are susceptible to faster rate of technical obsolescence. Hence, the auditor must take into consideration this fact while assessing the computation of provision for depreciation/amortization for such assets.

H. Depreciation and Useful Lives

Depreciation

4.53 Fixed assets are generally capitalized and depreciated when they are available for use. Available for use indicates that the asset is in the location and condition necessary for it to be capable of operating in the manner that management intends.

4.54 As per AS 6, Depreciation Accounting, depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes.

4.55 Accordingly, even if the fixed asset has not been put to use for production, it should be depreciated from the date it is available for use, since the factors of efflux of time and technological obsolescence cannot be ignored. The date of commercial launch is often considered as the "available for use" date. Commercial launch is not a defined term but is usually interpreted as the date when the engineers certify that testing has been completed and the fixed asset is capable of providing commercial production. Also, evidences in the form of RTO

Certificates/ other regulatory confirmations available to prove the launch of the product may be considered for corroborating the capitalization date.

4.56 The auditor should ensure that certificates from technical departments and other RTO and regulatory confirmations are available on record for all such major capitalizations.

Useful lives

4.57 Companies generally depreciate their fixed assets at rates specified in Schedule XIV of the Companies Act, 1956. Automotive companies work in an environment of rapidly changing technology. Companies should therefore evaluate whether depreciation charge based on Schedule XIV rates will represent an adequate depreciation charge.

4.58 If the useful lives are shorter than those envisaged under the Companies Act, the assets should be depreciated over the shorter life. The auditor should ensure that the rate adopted by the Company for depreciation is a correct measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes.

4.59 Due to continuous modifications and upgrades in vehicle models, the possibility of obsolescence is very high in this industry. The auditor needs to obtain a clear understanding of the product profile of the companies being audited. Whenever it comes to the notice of the auditor that a specific model is no more in vogue and is being phased out, suitable adjustments need to be made to the value of such model specific fixed assets carried in the books of account.

4.60 The estimate of useful life of a fixed asset should be reviewed by the management at least at each financial year end. If the estimates differ from the previous estimates, the un-depreciated cost should be written off to the statement of profit and loss over the revised remaining useful life (accelerated depreciation).

4.61 Where the change in asset life is significant, this may indicate that immediate impairment rather than a revision to the onward depreciation rate is necessary.

I. Impairment

4.62 AS 28 Impairment of Assets and Technical Guide on Estimation of Future Cash Flows and Discount Rates for the purposes of AS 28 issued by the Institute of Chartered Accountants of India should be referred for impairment testing. In the automotive industry, impairment testing is generally carried out on vehicles model wise as each vehicle model is a cash generating unit.

4.63 The auditor should ensure that wherever there are indicators of impairment, impairment testing is carried out by the Company.

Impairment indicators

4.64 Companies must assess at each balance sheet date whether there is any indication that an asset may be impaired. External factors and evidence from internal reporting may provide indicators that an asset may be impaired. Management should consider both general and automotive industry-specific factors, including:

- adverse trends in performance indicators such as reduction in sales, reduction in market share, the number of customers, increase in cost of production of the vehicles;
- plant's operating or maintenance expenditure significantly in excess of original budget;
- significant shortfall of revenues compared to budget or prior periods;
- technological developments that may reduce the economic performance of the assets (i.e. the technology related to the production becomes obsolete);
- impact of changes in regulation and deregulation; and

- increase in market interest rates.

4.65 As per AS 26, Intangible Assets, a tangible asset that is not yet available for use and an intangible asset that is amortized over a period exceeding 10 years from the date when the asset is available for use should be tested for impairment, even if there is no indication of impairment for that asset.

Cash generating units

4.66 A Company must determine whether the assets should be tested separately for impairment or as part of a cash generating unit (CGU). CGUs are the smallest group of assets, which includes the assets under review, which generates cash inflows that are largely independent from the cash flows from other assets or groups of assets.

4.67 The independence of cash flows will be indicated by the way management monitors the activities, for example by product lines or locations. A Company needs to consider if the vehicle line can be treated as a single CGU or complete factory would be a single CGU. Generally a vehicle line is treated as a single CGU.

4.68 The auditor needs to evaluate the assumptions in detail and should have reasonable and supportable basis for the management assumptions.

Calculating a CGU's recoverable amount

4.69 An asset's carrying value should not be greater than its recoverable amount, which is the higher of its value in use or net selling price. The CGU's recoverable amount must be calculated and compared with its net book value.

4.70 The Company's assumption would include volumes projections over the life of vehicle model, sales price per vehicle and cost per vehicle over the life of the model. Generally, companies launch new models at a low price and increase the price once the model sale increases. Further, over the years, cost per vehicle decreases due to localization of parts.

4.71 The auditor needs to evaluate the assumptions in detail and ensure that there is a reasonable and supportable basis for the management's assumptions.

Forecast horizon

4.72 Value in use is the net present value of the future cash flows expected to be generated from the CGU. Cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful lives of the assets or the CGU.

4.73 In the automotive industry, assessing life of the vehicle model is very complex. A model may run for 10 years and another model may not run for a complete year. Hence, the auditor needs to evaluate management assumptions in details. In India the small cars' life is generally more than that of the big cars. The projections should be based on management's most recently approved financial budgets/forecasts and should not exceed a period of five years unless a longer period can be justified. The projections beyond this point should be extrapolated using a steady or declining growth rate, unless an increasing rate can be justified. These projections should be extrapolated over the remaining useful life of the primary asset in the CGU.

4.74 The auditor needs to evaluate the assumptions in detail and ensure that there is a reasonable and supportable basis for the management's assumptions.

Capital expenditure

4.75 Future cash flows are estimated for the CGU in its current condition. Estimates of future cash flows should not include amounts expected to arise from improving or enhancing the CGU's current performance until the Company actually incurs capital expenditure that improves or enhances an asset in excess of its originally assessed standard of performance.

4.76 Determining whether items of capital expenditure complete, maintain or enhance the assets is often complex. Future capital expenditure necessary to maintain or sustain an asset at its originally assessed standard of performance should be included in the value in use calculation.

4.77 Most companies have significant capital expenditure programmes in place either for the newer version of the existing model or an entirely new vehicle model. Generally CGU in these cases is considered by taking together the existing model along with the improved version thereof.

4.78 The auditor has to exercise his judgement and obtain audit evidence that the determination made by management in respect of CGU is appropriate. The auditor should ensure that the Company follows a consistent policy to determine CGU's wherever impairment testing is done.

J. Leasehold Land/ Finance Lease

4.79 In the case of leasehold premises, capitalization and amortisation of lease premium, if any, should be examined.

4.80 As per AS 19 –Leases, a finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

4.81 AS 19 states that whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form.

4.82 Examples of situations given in AS 19, which would normally lead to a lease being classified as a finance lease are:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

- the lease term is for the major part of the economic life of the asset even if title is not transferred;
- at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

4.83 Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

Lease classification is made at the inception of the lease.

4.84 Leases which do not meet any of these criteria are to be accounted for as operating leases and require no entries to the fixed asset accounts.

4.85 The assets taken on finance lease may include certain plant and machinery, IT equipments etc.

4.86 The auditor should ensure that assets capitalized as finance lease satisfy the criteria given in AS 19 and that the accounting treatment followed is as per AS 19.

K. Product Development

4.87 In the automotive industry, there is a requirement to introduce new models frequently. Companies incur huge expenditure on product development to remain competitive. Major kinds of expenditure would include materials, labour and overhead costs, technical know-how, testing expenses, depreciation of

testing equipments, inspection costs etc. incurred while developing a new product.

4.88 In the automobile industry, product development expenditure could be categorized into the following broad heads:

- Vehicle on a totally new platform-New Generation of Vehicles.
- Variant of Existing Vehicles where model is derived from an existing platform.
- Projects which are undertaken to meet the legal requirements of either emission norms or safety.
- Enhancement : Enhanced specification and styling changes/ improvements.
- Fresh look / Face lift of vehicles with very restricted changes to the vehicle.
- Upgrade.
- Version changes with Addition / Deletion of features to existing model.

4.89 The auditor should ensure that expenses incurred under the various categories stated above are appropriately classified as either "research" or "development" in accordance with AS 26 – Intangible Assets. The auditor should also verify that there are proper internal controls in place to identify and record these expenditures appropriately. Once the particular model is developed, the cost incurred on the same during the development phase can be capitalized in accordance with AS 26. Expenditure on the research phase of an internal project should be recognized as an expense when it is incurred.

L. Borrowing Costs

4.90 In respect of borrowing costs, the auditor should ensure that the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalized as part of the cost of that asset, which would generally be in respect

of a new vehicle line or a new car/engine plant set up by the Company.

4.91 The auditor should ensure that the borrowing costs are capitalized as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the Company and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which it is incurred.

4.92 The auditor should ensure that the borrowing costs incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted, is not capitalized, unless such temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

M. Physical Verification of Fixed Assets

4.93 In respect of fixed assets, the auditor should pay particular attention to the system of recording the movements as well as other controls over fixed assets, e.g., their physical verification at periodic intervals by the management and/or by internal audit team. He should also examine whether discrepancies have been properly dealt with in the books of account and adequate provision in respect of any damaged assets has been made.

4.94 The auditor should also evaluate the reasonableness of the intervals at which management or the internal audit team physically verifies the other assets.

N. Fiscal Benefits for Investments in Fixed Assets

4.95 Some automobile companies are eligible for getting various incentives/benefits from Government agencies for setting up their manufacturing plant at a specific location. One of the conditions normally specified for such cases is a minimum prescribed amount of investments in fixed assets. The companies also need to furnish such details of fixed assets to the agencies in order to get the eligible benefits and in certain cases cannot dispose of the assets without obtaining prior permission from the Government agencies. The auditor should review such arrangements with the

Government agencies and ensure that the Company complies with the conditions prescribed in the same. The auditor should also ensure that the Company maintains the details in the specified format and also corroborate the returns/other documents filed with the Government agencies in order to ensure that the same are in line with the details as per the books of account.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material misstatement

4.96 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering "what can go wrong" for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

4.97 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor's cumulative knowledge of the entity.

4.98 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

4.99 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity's controls, including control activities, relevant to that risk.

4.100 Hence, these audit procedures will vary according to the given situation.

Material Classes of Transactions , Account Balances and Disclosures	Assertions		Illustrative Audit Procedures (these procedures will vary according to the given situation)
Fixed Assets			
		A	**System update**
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes.
		B	**Recording accuracy**
	Completeness	1	Obtain/prepare a schedule of fixed assets, showing, for each major category, the amounts of cost (or other valuation) and accumulated depreciation at the beginning and end of the year, and movements during the year. Check the totals and agree the closing balances to: • Trial balance. • General ledger. • Balance sheet. • Opening balances to prior year financial statements. • Depreciation charge to the profit and loss account.
	Completeness	2	Agree the original cost, accumulated depreciation and written down value as on the beginning and end of the year to the fixed assets register.
	Completeness	3	Review the fixed assets register and ensure that the necessary details are recorded for each fixed asset.
		C	**Review of balances**

	Valuation & Allocation, Rights & Obligations	1	Review and explain movements between the current year, prior year and budgeted amounts for: • additions and disposals by class of asset. • repair and maintenance expenses. • depreciation charges. Where amounts appear excessive or inadequate based on the knowledge of the business, investigate the reasons for the same.
	Valuation & Allocation	2	Review entries in respective ledger accounts for the year and investigate unusual items.
	Valuation & Allocation	3	Review the ratio of depreciation charge for each major category of fixed assets with agreed depreciation rates and with the ratio for the previous year. Investigate any significant variations.
		D	**Test property balances**
	Valuation & Allocation, Rights & Obligations	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on property and accumulated depreciation balances.
		2	Obtain schedules of property, plant and equipment showing beginning and ending balances, purchases, sales, and other acquisitions and disposals during the current period, as well as accumulated depreciation at the beginning and end of the period. The schedules should show property by category or type of asset,

			with the date of purchase of each significant item and, where applicable, the sales proceeds and profit or loss on a disposal.
	Completeness		• Test summarization of the schedule.
	Completeness		• Agree beginning balance to prior year working papers.
	Completeness, Valuation & Allocation, Rights & Obligations		• Trace totals of property and accumulated depreciation to the general ledger and fixed assets register. Trace gain or loss on disposals to the general ledger. Trace significant reconciling items, if any, to supporting documents.
	Existence	3	Obtain from the entity, a copy of the instructions of physical verification of fixed assets.
	Existence, Valuation & Allocation	4	Determine that management has verified fixed assets during the year and discrepancies noted on such verification have been properly dealt with in the books of account.
		5	Make a selection of fixed assets from the beginning cost column and the current period purchases/ acquisitions column of the schedules and perform the following:
	Existence, Rights & Obligations		• Physically inspect the asset, if possible, or determine by other means that the asset is owned and still in use by the entity, and that the remaining useful life appears to be reasonable in relation to its condition and estimated

			future use.
	Valuation & Allocation, Rights & Obligations		• Trace the recorded costs of the selected asset to supporting documents (e.g. capital expenditure approvals and vendor invoices for purchases in the current year, the prior-year working papers for assets purchased in prior years).
	Valuation & Allocation, Rights & Obligations		• Determine that current period additions are properly approved and include no amounts of an expense nature.
			• Determine that the current period additions include expenses incurred only up to the date of installation.
			• If an addition replaces an asset, determine that the asset replaced was properly treated as a disposal.
		6	Make a selection of fixed assets from the current period sales/disposal column of the schedules and perform the following:
	Valuation & Allocation, Rights & Obligations		• Examine the documents authorizing the disposal and supporting the amounts for which the selected assets were sold (e.g. cash receipts).
	Valuation & Allocation		• Recompute the gain or loss on disposal.
	Valuation & Allocation, Completeness	7	Perform substantive analytical procedures to test property balances. Consider using the

			following data, as applicable, to develop expectations of property balances:
			• Prior year property balances.
			• Monthly amounts of property purchases and sales, write-offs, and gain or loss on disposals.
	Completeness	8	Determine that the data used to make independent estimates is independent and reliable and if information produced by the entity is used, obtain audit evidence about the accuracy and completeness of the data.
	Accuracy	9	If the data is not independent, separately audit the data. In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was generated.
	-	10	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded year end property balances that is acceptable without further investigation.
	-	11	Compare the expectation to the recorded balance and identify any differences. For any difference, that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full

			amount of the difference, not just that part that exceeds the threshold.
			We also consider investigating the following:
	Valuation & Allocation		• Any unusual pattern in the differences.
	Valuation & Allocation		• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud.
	Valuation & Allocation	12	Specifically, determine that the accounting policies and procedure for capitalization of assets costing below Rs.5,000 are appropriate and are applied consistently.
	Valuation & Allocation	13	Review changes in property categories during the period and consider their reasonableness in view of prior history and current information, such as increased productivity, business plans, etc.
	Valuation & Allocation	14	Determine that events have not occurred that might lead to a reduction in the period over which an asset is being written off, or, in the extreme, lead to a total write-off of an asset (e.g. changes in production rendering some assets obsolete).
	Valuation & Allocation	15	Review the repairs and maintenance expense accounts

			for the period and determine whether there are items which should have been capitalized.
	Valuation & Allocation	16	For assets transferred from one location to another, verify that the transfers are at book value.
	Rights & Obligations	17	Verify the register of charges and identify assets on which a charge has been created.
	Valuation & Allocation	18	Obtain the information necessary to audit the cash flow statement.
		19	Evaluate results of the tests.
		E	**Test Capital Work In Progress**
		1	Obtain a schedule of capital work in progress and capital advances paid showing beginning and ending balances, value of purchase orders, additions during the period, capitalization during the period and projects written off during the period. The schedules should show details by capital purchase order/work order (including those where work has not commenced), with the date of purchase order, date of advance and, where applicable, the sales proceeds and profit or loss on a disposal.
	Completeness		• Test summarization of the schedule.
	Valuation & Allocation		• Agree beginning balance to prior year working papers.
	Valuation & Allocation, Completeness		• Trace totals of capital work in progress and capital advance to the general ledger. Trace gain or loss on disposals to the general ledger. Trace significant

			reconciling items, if any, to supporting documents.
	Valuation & Allocation		• Recompute capital commitments at the year-end and verify that these are net of advances paid.
		2	Make a selection of projects from the beginning column and the current period additions column of the schedules and perform the following:
	Valuation & Allocation, Rights & Obligations		• Trace the recorded costs of material and labour to supporting documents (e.g. capital expenditure approvals and vendor invoices for purchases in the current year, the prior-year working papers for assets purchased in prior years), evidence of receipt, labour records and rates and determine that the items have been properly included as capital assets.
	Valuation & Allocation		• Determine that current period additions are properly approved and include no amounts of an expense nature.
	Valuation & Allocation		• Recompute overheads (including interest capitalized) and determine that these have been properly included in the project cost.
		3	Make a selection of projects from the current period adjustment column of the schedules and perform the following:

	Valuation & Allocation		• On abandonment of a project, recompute the gain or loss on disposal. Examine the documents authorizing the disposal and supporting the amounts for which the selected assets were sold (e.g. cash receipts).
	Valuation & Allocation	4	Inquire of any delay in completion of a project and the likelihood of the project being abandoned.
	Valuation & Allocation, Completeness	5	Verify that fixed assets in transit and considered as capital work in progress at the year-end has been subsequently received.
	Valuation & Allocation, Completeness	6	Review the general ledger for the period after the year-end and investigate for any assets sold or scrapped after the year-end. Consider the requirement of an impairment of such assets existing at the year-end.
	Valuation & Allocation	7	For a selected period before the year end, investigate for any journal entries recorded for adjustment of fixed assets. Test the appropriateness of journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements.
	Existence	8	Prepare, or have the client prepare, standard confirmation requests for capital advances and perform the following:
			• Mail the confirmation requests under the auditor's control, determine

			that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the client) and request that all replies be sent directly to the auditor's office.
			• Send second requests for non-replies. Request the client to follow up, if necessary.
			• Compare replies to the schedule of capital advances.
	Valuation & Allocation	9	Review capital advance accounts with significant credit balances and check for any misstatements.
			• Inquire into any significant disputed balances. Investigate as necessary.
	Valuation & Allocation **Valuation & Allocation**	10 11.	Prepare a list of advances which, in your opinion, are doubtful of recovery with reasons and discuss the same with the management. Examine the documents authorizing the completion of installation and commencement of commercial production.
		12	Evaluate results of the tests.
		F	**Test valuation of property**
	Valuation & Allocation, Rights & Obligations	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on property and accumulated depreciation balances. Specifically, determine that the

			accounting policies and procedure for calculating and recording depreciation are appropriate and are applied consistently.
	Valuation & Allocation, Completeness	2	Perform substantive analytical procedures to test depreciation expense. Consider using the following data, as applicable, to develop an expectation of depreciation expense at the year-end:
			• Property balances during the year and in prior years, depreciation expenses in prior years, stated depreciation lives and depreciation rates.
	Valuation & Allocation, Completeness	3	If necessary, disaggregate both the data used to build the expectations and the recorded depreciation expense at a level of detail sufficient to enable us to obtain the desired level of assurance based on a comparison of amounts. Consider using the following means by disaggregation:
			• By category or type of asset. • By period. • By depreciation method. • By division or location.
	Completeness	4	Determine that the data used to make independent estimates is independent and reliable and if information produced by the entityis being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation &	5	If the data is not independent,

	Allocation		separately audit the data. In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was generated.
	-	6	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded amounts that is acceptable without further investigation.
	-	7	Compare the expectation to the recorded balance and identify any differences. For any difference, that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		8	We also consider investigating the following:
	Valuation & Allocation		• Any unusual pattern in the differences.
	Valuation & Allocation		• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or

			pervasive risk as a result of fraud risks.
		9	Make a selection of fixed assets from the schedule tested in Step D.5 and D.6 above and perform test of detail for depreciation expense.
	Valuation & Allocation		• Recompute the current period depreciation expense amount and reconcile the beginning accumulate-ed depreciation amount to the ending amount.
	Completeness		• Test summarization of the schedule and trace ending balances of accumulated depreciation to the general ledger.
	Valuation & Allocation		• Inquire into other significant entries recorded in the depreciation expense account. Investigate these entries and trace them to supporting documentation.
		10	Evaluate results of the tests.
		G	**Gain or loss on disposal of property**
	Valuation & Allocation	1	Using the schedule obtained in Step D.6 above, test related gain or loss on disposals for the current year by performing substantive procedures as noted below:
		2	Make a selection of fixed assets from a reciprocal population to test disposals for understatement. The reciprocal population to be used is the total of property, plant and equipment from the beginning cost column

			and the current period purchases/acquisitions columns of the schedules.
	Existence, Rights & Obligations		• Determine that the selection is a valid asset or addition, still in use and that it is not a disposal.
	Existence, Rights & Obligations		• For each selection, physically inspect the asset, if possible, and contact the management to corroborate that the asset is still in use by the entity. Determine that the remaining useful life appears to be reasonable in relation to its condition and estimated future use.
	Completeness		• For the step above, inquire as to whether or not the individual is aware of any other disposals during the period under audit. If so, corroborate that the disposal is noted in the schedule obtained in Step D.6 above.
	Completeness	3	Make a selection of fixed assets from a reciprocal population to test the gain on disposal for understatement. The reciprocal population to be used should be total disposals noted on the schedule obtained in Step D.6 above.
			• Verify that the disposal was accurately recorded in the proper period.
		4	Evaluate results of the tests. Also evaluate whether losses on

			disposal indicate an inadequate depreciation charge or the fact that certain other assets within the class may be impaired.
		H	**Roll forward test for property tested prior to year end**
	Valuation & Allocation, Completeness	1	Inquire, and consider any other evidence that comes to our attention, as to any significant acquisitions or disposals in the intervening period from the interim testing date to the balance sheet date. Test any such acquisitions or disposals as in Step D.5 and D.6.
		2	Test transactions during the intervening period between the interim testing date and year end.
	Completeness		• Obtain a reconciliation of the interim property balance to the year-end balance.
	Completeness		• Agree purchases totals to purchases or cash disbursements journals.
	Completeness		• Agree sales totals to sales or cash receipt journals.
	Valuation & Allocation, Rights & Obligations		• Examine supporting documents to verify other significant entries.
	Valuation & Allocation		• Ensure compliance with section 293 of the Companies Act in case of sale of an undertaking.
		2	Make a selection of property purchases or other acquisitions in the intervening period between the interim testing date and year-end.

	Valuation & Allocation, Rights & Obligations		• Trace to supporting documents (e.g. capital expenditure approvals and vendor invoices).
	Valuation & Allocation		• Determine that amounts of an expense nature are not included.
	Valuation & Allocation		• If an addition replaces an asset, determine that the asset replaced is properly treated as a disposal.
		3	Make a selection of property sales or other disposals in the intervening period between the interim testing date and year end.
	Valuation & Allocation, Rights & Obligations		• Examine documents authorizing the disposal and supporting the amounts for which the selected assets were sold.
	Valuation & Allocation		• Recompute the gain or loss on disposal.
	Valuation & Allocation, Completeness	4	Perform substantive analytical procedures to test property balances at year end. Consider using the following data, as applicable, to develop expectations of property balances at year end:
			• Prior-period property balances; monthly amounts of property purchases and sales, write offs, and gain or loss on disposals, in the intervening period from the interim testing to the balance sheet date, compared to such monthly amounts in prior years and in the current year prior to

			the interim testing date.
		5	Determine that the data used to make independent estimates is independent and reliable and if information produced by the entity is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation	6	If the data is not independent, separately audit the data. In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was generated.
	-	7	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded year-end property balances that is acceptable without further investigation.
	-	8	Compare the expectation to the recorded balance and identify any differences. For any difference, irrespective of the direction of the primary test, that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		9	We also consider investigating the following:
	Valuation & Allocation		• Any unusual pattern in the differences.

	Valuation & Allocation		• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud.
		10	Evaluate results of the tests.
		I	**Test Intangible Assets (Other than Goodwill)**
		1	Obtain schedules of patents, copyrights, and other intangible assets, showing beginning and ending balances and acquisitions and disposals during the current period, as well as amounts written off during the period. The schedules also need to show a description of each asset, the date of acquisition, the useful life (if applicable), and the sales proceeds and profit or loss on a disposal (if applicable).
	Completeness		• Test summarization of the schedule.
	Completeness		• Trace year-end asset totals to the appropriate balance sheet account in the general ledger and charges for the year (i.e. amortization and/or impairment charges) to the appropriate income statement account in the general ledger.

	Valuation & Allocation		• Verify that costs that should have been expensed in current or past periods are not being carried forward.
	Valuation & Allocation		• Verify that costs of internally developing, maintaining, or restoring intangible assets that are not specifically identifiable, or are inherent in a continuing business related to the entity as a whole have been expensed as incurred.
		2	Make a selection of intangible assets from the beginning cost column and the current year acquisitions column of the schedules.
	Valuation & Allocation, Rights & Obligations		• For intangible assets not acquired in the current year, trace the recorded value of the selected intangible assets to supporting documents (e.g. our prior year working papers for intangible assets acquired in prior years).
	Valuation & Allocation		• For intangible assets that were acquired individually or with a group of other assets in the current year (other than those acquired in a business combination), verify that intangible assets were recognized and measured at cost.
	Valuation & Allocation		• Verify that selected intangible assets have not been written down and/or written off unless they

			became impaired.
	Valuation & Allocation, Rights & Obligations		• Trace additions to the appropriate authorizations or board minutes.
	Valuation & Allocation, Rights & Obligations		• Trace additions to independent supporting evidence (e.g. copies of wireless licenses), if applicable.
		3	For those intangible assets selected in Step 2 that were disposed of during the current period:
	Valuation & Allocation, Rights & Obligations		• Examine documents supporting the amounts for which the selected intangible assets were disposed (e.g. cash receipts).
	Valuation & Allocation		• Recompute the gain or loss on sale.
		4	Evaluate results of the tests.
		J	**Test valuation of Intangible Assets (Other than Goodwill)**
	Valuation & Allocation, Rights & Obligations	1	Determine that the accounting policies and methods for intangible assets are appropriate and are applied consistently. Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on valuation of intangible assets.
	Valuation & Allocation, Rights & Obligations	2	Determine that intangible assets are being amortized over their useful lives (i.e. the period over which the asset is expected to contribute directly or indirectly to the future cash flows of the

			entity). If the useful life exceeds 10 years, ensure that it is tested for impairment at the balance sheet date even if there is no indication of impairment. (Such testing is required for intangible assets not yet available for use also).
		3	Make a selection of the intangible assets tested in Step J.2, and perform tests of details for amortization expense.
	Valuation & Allocation		• The method of amortization should reflect the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight line amortization method should be used.
	Valuation & Allocation	4	Verify that the useful life of each intangible asset that is being amortized has been evaluated at each reporting date to determine whether events and circumstances warrant a revision to the remaining period of amortization.
			• If the intangible asset's remaining useful life has changed, determine that the remaining carrying amount is being amortized prospectively over the revised remaining useful life.
		5	Evaluate results of the tests.
		K	**Test capital (finance) leases where entity is a lessee**

		1	Obtain schedules of capital (finance) leases where entity is a lessee showing beginning and ending balances and lease additions and terminations during the current period and perform the following:
	Completeness		• Test summarization of the schedule.
	Completeness		• Trace ending balances to the general ledger.
	Valuation & Allocation, Rights & Obligations		• Trace details to agreements.
	Valuation & Allocation		• Determine the propriety of capitalization for items included.
	Valuation & Allocation		• Determine the propriety of the depreciation methods used.
		2	Make a selection of items from the beginning balances and current period additions column of the schedule.
	Existence		• Physically inspect the asset, if possible, or determine that the asset exists and is in use by the entity.
	Valuation & Allocation, Rights & Obligations		• Trace the minimum lease payments and the period of the lease to supporting documents (e.g. lease agreements).
	Valuation & Allocation		• Recompute the net present value and interest amount expensed during the current period.

	Valuation & Allocation		• Recompute current period depreciation expense.
	Existence, Valuation & Allocation	3	Prepare, or have the entity prepare, confirmation requests for all leases at Step K.1. On the confirmation, consider including outstanding balance, installments paid, rate of interest and interest expenses.
			• Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the entity) and request that all replies be sent directly to the auditor's office.
			• Send second request for non-replies. Request the entity to follow up, if necessary.
			• Compare replies to requests. Prepare, or have the entity prepare, reconciliation of exceptions. Trace reconciling items to supporting documents (e.g. lease agreements, bank statements) and determine that the asset, liability and interest expenses have been properly recorded.
			• Trace non-replies to subsequent cash payments.
			• Inquire into any significant disputed balances.

			Investigate as necessary
	Completeness	4	Make inquiries of management, and consider whether evidence obtained from other audit procedures indicates the existence of additional leases.
	Valuation & Allocation	5	For those assets selected in Step K.2 that were no longer leased at the year end, determine that the lease termination was authorized and was recorded properly.
		6	Evaluate results of the tests.
		L	**Test capital (finance) leases where entity is a lessor**
		1	Obtain schedules of capital (finance) leases where entity is a lessor showing beginning and ending balances and lease additions and terminations during the current period and perform the following:
	Completeness		• Test summarization of the schedule.
	Completeness, Valuation & Allocation		• Trace the lease income to the general ledger and cash receipt records.
	Completeness	2	Make inquiries of management, and consider whether evidence obtained from other audit procedures indicates the existence of additional leases.
		3	Make a selection of items from the beginning balances and current period additions column of the schedule.
	Valuation & Allocation, Rights & Obligations		• Trace the minimum lease payments and the period of the lease to supporting documents (e.g. lease agreements).

	Valuation & Allocation		• Recompute the net present value and interest income during the current period.
	Valuation & Allocation		• Recompute current period depreciation expense.
	Completeness	4	Obtain the schedule of unearned income and test the reconciliation of opening and closing balances as well as movements of the period to the general ledger.
	Existence, Valuation & Allocation	5	Prepare, or have the entity prepare, confirmation requests for all leases at Step L.1. On the confirmation, consider including outstanding balance, installments received, rate of interest and interest received.
			• Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the entity) and request that all replies be sent directly to the auditor's office.
			• Send second request for non-replies. Request the entity to follow up, if necessary.
			• Compare replies to requests. Prepare, or have the entity prepare, reconciliation of exceptions. Trace reconciling items to supporting documents (e.g. lease agreements, bank

			statements) and determine that the asset, liability and interest expenses have been properly recorded.
			• Trace non-replies to subsequent cash payments.
			• Inquire into any significant disputed balances. Investigate as necessary.
		6	Evaluate results of the tests.
		M	**Test presentation of property balances and intangible balances**
	Classification & Understand-ability, Accuracy & Valuation	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on presentation of fixed assets.
	Classification & Understand-ability, Accuracy & Valuation, Occurrence & rights and obligations	2	Determine that amounts presented as fixed assets are properly recorded, classified and/or disclosed as required by Schedule VI of the Companies Act: • Heads of assets as specified. • Under each head, original cost, additions, deduction, accumulated depreciation. • Where assets have been revalued: ⁎ each balance sheet should show the increased/ reduced figures with the date of revaluation. ⁎ each balance sheet for first five years should show the amount of increase/decrease

			made. • Estimated amount of contracts remaining to be executed on capital account and not provided for. • Net book value of assets on hire purchase. • Fixed assets acquired on lease not included in schedule of fixed assets. • Future obligations in respect of leased assets. • General description of depreciation methods for major classes of property. • Total amount of depreciation charged to expense. • Property mortgaged and encumbered by indebtedness.
	Classification & Understand-ability, Accuracy & Valuation,	3	Determine that the following items have been properly presented in the financial statements:
			• All intangible assets have been aggregated and presented as a separate line item in the statement of financial position. However, that requirement does not preclude presentation of individual intangible assets as separate line items.
			• The amortization expense and impairment losses for intangible assets are presented in income statement line items within

			continuing operations.
	Classification & Understand-ability, Accuracy & Valuation,	4	Determine that the following disclosures, if applicable, have been made:
			• Balances of significant intangible assets segregated by type. • General description of amortization methods for major classes of intangible assets.
		N	**Conclusion**
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.
	-	2	Consider including the following when documenting the conclusion: • A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. • The relevant potential errors and control objectives for each account balance or disclosure being tested. • The substantive procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors. • The results of the

			substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure. • The tests of controls we performed or a cross reference to where the tests of controls performed are documented. • The results of the tests of controls, including deficiencies identified, and how such results support the conclusion as to whether we have obtained control reliance for the potential errors for each account balance or disclosure.

Chapter 5
Inventories

Definition of Inventories

5.1 Inventories are defined as assets:

a) held for sale in the ordinary course of business;

b) in the process of production for such sale; or

c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

5.2 While auditing inventories, the auditor should keep in mind the general rule for deciding whether an item should be treated as inventory or not, which is basically to determine the purpose for which the entity is using the item. If the purpose is any of the three alternatives mentioned above, the item should be treated as inventory. Particular care is required in the case of moulds, the treatment of which can vary according to the arrangement with the supplier. For instance, where the mould belonging to the supplier of an original car manufacturer is used for the manufacture and supply of components, it is capitalized in the books of the supplier. However where, the supplier manufactures and sells the mould to the original car manufacturer, but retains possession on behalf of the original car manufacturer so as to manufacture and supply components, the mould is treated as inventory by the supplier till it is sold to the original car manufacturer at which time the original car manufacturer will capitalize the same in their books. The auditor should ensure that all arrangements in this respect are checked with correspondences and agreements in this respect.

Specific Items

5.3 This section deals with some specific items which are important in relation to the automotive industry.

1) **Consumable supplies**: Consumable supplies are divided into two major parts:

   a) ***Production supplies****:* Production supplies are used in the production process- they are also known as indirect materials. Production supplies may consist of, fuel, gas, propellants, oil, grease and grinding materials, supplies used in the commercial area such as in the workshop of a dealer, etc. The auditor should ensure that production supplies should be treated as inventories unless they are of insignificant value, in which case they should be expensed off immediately. The auditor should ensure that there are adequate internal controls and procedures in respect of the procurement of these items and proper records are kept for these inventories.

   b) ***Other supplies:*** Other supplies are used for product development, product instructions, printed matter and other office supplies. They are immediately expensed off at the time of acquisition. However, supplies purchased and held in larger quantities for commercial and service activities, should be treated as inventories.

2) **Produced vehicles:** Vehicles produced by the entity are divided into following categories.

   a) ***Vehicles to be used for product development****:* These vehicles are manufactured to support or improve the production activity and they are not manufactured for permanent use and therefore the auditor should ensure that they should not be considered as fixed assets and should be

considered as a part of inventory. These should be charged off to expenses when the product is disposed or scrapped.

b) ***Vehicles for demonstration and public relations activities:*** The auditor should ensure that these vehicles are treated as inventory instead of fixed assets.

5.4 Following are examples of items which the auditor should ensure are not treated as inventories

- Standby equipment and replacement parts which can be used only in connection with an item of machinery and equipment and whose use is expected to be irregular are classified as fixed assets and accounted for accordingly. Minor replacement parts are expensed off on acquisition.

- Type-bound tools are not treated as inventories and form part of fixed assets.

- Leased vehicles are not treated as part of inventory.

Inventories Classification

5.5 In the automotive industry, inventories are classified under following category:

1) Production inventory,

2) Finished goods, and

3) Inventory (components) held for service and maintenance contracts.

A. Production Inventory

5.6 Inventories that are not classified as finished goods or components for service and maintenance contracts are classified as production inventories. Examples:

- Raw materials,

- Production materials,
- Consumable supplies,
- Work in progress.

B. Finished Goods

5.7 Finished goods are inventories ready to be sold to the customers. While auditing for inventory, it should be taken care that these have been distinguished from work in progress. A certain item (e.g. an engine) can be treated as finished goods in the financials of one Company and work in progress in the financials of another Company. Finished goods are accounted for as inventories till the time they are sold to the customers and revenue is recognized.

C. Inventory (Components) Held for Service and Maintenance Contracts

5.8 Automobile manufacturers are required to keep inventory of components for service and maintenance purposes for specified period of time as mandated by regulatory authorities from time to time for each model. For instance, a particular model may be withdrawn from production and distribution. However, to ensure that the users who have purchased these models in past years can get these models repaired/ serviced in the future, automobile companies need to carry these inventories. The auditor should ensure that there is a proper system of technical evaluation to ensure proper valuation of such inventories at each reporting date.

D. Goods in Transit/Goods on Consignment

5.9 Goods-in-transit are the goods that have not yet arrived at the premises of the receiver but for which the supplier has fulfilled all the delivery obligations.

5.10 Goods on consignment are goods delivered to an external party who holds them on behalf of the delivering Company.

5.11 In the automotive industry, goods-in-transit and goods on consignment form a very significant part. The auditor should ensure that goods-in-transit are shown as inventory of the receiver entity and goods on consignment shown as inventory of the delivering entity.

Valuation of Inventories

5.12 Valuation of inventory in the automotive industry is carried out as per AS-2 Valuation of Inventories.

5.13 A detailed list of the types of costs to be included in the valuation of inventory in the automotive industry is stated in the box below.

Relevant types of costs to be included in the inventory value

The following list contains the types of costs that are relevant for inclusion in the value of finished goods.

1. Purchased materials

- Net purchase price.
- Import duties.
- Non-recoverable purchase taxes.
- Freight, packing and handling costs.
- Cost of tools and equipment entrusted to suppliers or subcontractors.
- Rejections and reworks.
- Operating expenses of the purchasing, procurement, incoming goods and quality control functions.

2. Production charges

- Direct manufacturing labor (wages, social charges and other personnel expenses) including direct temporary labor.
- Indirect manufacturing labor.
- Subcontracted production.
- Energy and water.
- Consumables.

- Maintenance of factory buildings, machinery and equipment.
- Historical cost depreciation of factory buildings, machinery and equipment.
- Patents and royalties.
- Insurance premiums on production related equipment.
- Indirect taxes.
- Data processing relating to production activities.
- Cleaning, security and other services.
- Internal transport.

Valuation of Raw Materials

5.14 The auditor should ensure that raw materials are accounted for on the basis of actual cost incurred by the Company for purchase of the raw materials including the incidental costs such as rates and taxes, freight etc. There should not be any loading of indirect expenditure like salary cost or other overheads of the purchasing department in the cost of raw materials.

Valuation of Semi- Finished Goods and Finished Goods

5.15 In the automobile industry, cost of finished and semi-finished goods is calculated on the basis of Bill of Material (BOM) which is prepared for each product. At the time of checking the inventory valuation of finished goods, the auditor should ensure that all the items used for the production of goods are included with correct quantity in BOM and the BOM is valued on the basis of actual cost incurred by the entity instead of standard cost (used for the purpose of MIS). Standard cost may be used only if the results approximate the actual cost. In addition to that, as stated in AS-2, other variable and fixed overheads should also be allocated on semi-finished goods and finished goods on the basis of actual cost. The auditor should analyze the variances between the standard cost and actual costs incurred and obtain reasons for such variances from the management to ensure that there are no abnormal wastages/ pilferages. In case of abnormal wastages, the

auditor should ensure that these are charged off to the statement of profit and loss and not inventorized.

5.16 In case of overheads where standard costing is used, variances between standards set and actual costs incurred are calculated and loaded on to closing stock of inventory.

General Description and Rules

5.17 If the net realizable value is lower than the historical cost, the auditor should ensure that the carrying value of such inventories have been written down to the net realizable value. In case where the net realizable value of finished goods is lower than cost, write down may be required for materials and other supplies held for use in production.

5.18 The carrying value of inventories can be written down because of physical or economic factors. They are listed as follows:

- When the product has been damaged or measures are needed to be taken for some reason to rectify the product before its use or sale.
- When the product is outdated or over-stocked.
- When the estimated net sales value does not cover already incurred and future costs related to the sales.

5.19 The write-down should be made as soon as the risk is observed or there are reasonable grounds to suppose that it exists. For products intended to be scrapped, a 100% provision should be made. The historical cost is retained in the accounts until the products have been physically scrapped or disposed off. All changes in the provision for diminution in the value of inventory are included in the statement of profit and loss. The auditors should ensure that the Company has a proper system to evaluate and identify non-moving/ slow moving items like stock of outdated models. Adequacy of provisions for such items made in the books of account should also be verified.

Inventory Control

Inventory Record and General Ledger

5.20 The auditor should check whether the entity has maintained proper inventory records of both quantities and cost.

5.21 While these records need not necessarily be maintained in the accounting department, under no circumstances should they be the responsibility of or in the custody of persons having access to or control over inventories, (i.e. purchasing, production, warehousing, incoming goods or shipping).

5.22 Where amounts are significant, separate sets of perpetually-updated inventory records, supported by ledger control accounts, should be maintained as follows:

- Raw materials.
- Production materials.
- Consumable supplies.
- Work in progress.
- Finished goods.
- Parts.
- New vehicles.
- Used vehicles.
- Inventory (components) held for service and maintenance contracts.
- Goods on consignment.

5.23 It is permissible to perpetually update records for work in progress and inventory (components) held for service and maintenance contracts, provided procedures exist for:

- Constant monitoring of the value of such inventory in relationship to factory loading,
- Assignment to a particular job, lot or department of each item of material, labour, overheads and additional costs where this is warranted,

- Constant controlling of work in progress by prompt close out and costing of completed jobs.

5.24 Balances of perpetual inventory records should be reconciled with the general ledger control accounts regularly.

Physical Stock Taking

5.25 As the inventory in the automotive industry is prone to theft or damage, adequate safeguards should exist to protect the inventory against theft, fire and other risks. A physical stock taking should be carried out at regular intervals by people independent of stock handling and recording in order to substantiate the accuracy of perpetual inventory records. This can take the form of a complete physical count at one time, or cyclical counts during the year, or even a statistical count where appropriate conditions exist to allow this.

5.26 All arrangements for physical stock taking should be reviewed by the external auditors to ensure the acceptability of the physical inventory results. The general ledger value should be adjusted immediately to reflect the result of the stock-taking.

5.27 Analyses of perpetual inventory should be performed regularly to identify obsolete, aged and excess goods. Physical stock taking should also be conducted in a manner that could identify damaged goods, so that these goods may be realistically valued and, where appropriate, steps can be taken for their disposal.

Verification of Inventory Consumption

5.28 Generally in the automotive industry, products have a specific bill of material (BOM) and consumption should not vary significantly as compared to the BOM. Consumption of raw materials or finished goods is verified by the auditor by comparing the consumption with that stated in the BOM specified for the product. The auditor should document all the variances observed, if any, in respect of any of the models and should discuss these variances with appropriate level of management.

Inventories with Third Parties

5.29 The auditor should ensure that the entity maintains proper records in respect of all its inventories lying with the job worker or third parties for processing. It should be ensured that for each reporting period, confirmations are received from each of such parties and they are valued properly. The auditor should verify that there is proper physical verification of these inventories conducted by the Company at regular intervals. The auditor should ensure that there is a proper system of monitoring wastages, obsolescence and slow moving items. This is a very important area in the automotive industry because a number of components are fabricated at third party premises and there is considerable movement of materials. The auditor should look into the agreement with these third parties and look into various aspects such as quantum of wastage allowed, quantitative reconciliation, input-output ratio used by such third parties in arriving at the wastages, excise records etc.

5.30 In case, these job workers happen to be related parties, the auditor's extent of checking may increase, considering the control environment of the entity.

5.31 Further, the auditor should also reconcile the movement in materials with the excise records and ensure compliance with all the excise rules.

Accounting for Scrap

5.32 Scrap is an important component in the manufacture of vehicles/automobile components. The scrap generation and the process in place surrounding the monitoring of such scrap is an important factor in establishing the internal controls operating in the inventory business cycle. The auditor needs to obtain a clear understand of the type and nature of scrap generated by the automobile companies and use the same in devising audit procedures for testing inventory. In particular, the auditor may consider the following:

- analyses the source, nature and extent of scrap generated during each month.
- obtain reasons for the significant variations in the scrap generated each month and corroborate the reasons with the variations in the consumption of the related source materials, the relevant input output ratios, the work in progress as at the end of the month and the finished goods manufactured during the month.
- check the excise records/production records to confirm the nature and extent of scrap generated.
- analyses the process followed by the Company for the sale of scrap and the approval mechanisms in place.
- depending on the nature, extent and value of scrap generated and the sales pattern, consider the need for treating unsold scrap generated as inventory as at the balance sheet date.

5.33 Where such scrap is treated as inventory, valuation should normally be after taking into account the realizable value of such scrap. The auditor needs to verify the past sales pattern to ensure that the valuation is appropriate.

Accounting for Price Revisions

5.34 The main raw materials involved in the automobile industry are subject to periodical price revisions from the suppliers. The auditor should have periodical discussions with the client personnel to understand the process of such price revisions and make sure that such revisions are appropriately dealt with in the books of account of the Company. The auditor also needs to make sure that the impact on account of such price revision on the inventory balances are duly given taking into account the period for which the price revisions are given effect to.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material misstatement

5.35 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering "what can go wrong" for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

5.36 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor's cumulative knowledge of the entity.

5.37 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

5.38 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity's controls, including control activities, relevant to that risk.

5.39 Hence, these audit procedures will vary according to the given situation.

Inventory

Material Classes of Transactions, Account Balances and Disclosures	Assertions		Audit Procedures
Inventory		**A**	**System update**
			Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	**Recording accuracy**
	Existence	1	Obtain a schedule of inventories and the detailed priced stock ledger.
	Completeness	2	Check the totals of the stock ledger and the schedule.
	Completeness	3	Trace amounts in the - schedule to the stock ledger and agree the totals to the general ledger, trial balance and the balance sheet.
		C	**Review of balance**
	Valuation & Allocation, Rights & Obligations, Completeness, Existence	1	Review and explain movements between current year, prior year and budgeted amounts for year-end stocks segregated by type and, if possible, further broken down by product lines and/or location as follows: • Amounts as a

			percentage of total. • Finished goods in terms of number of months cost of sales. • Raw materials in terms of number of months usage. • Inventory aging .
		D	**Observe and Test Count Inventories**
		1	Prior to and/or on the date at which physical inventories will be observed:
	Existence		• Obtain from the entity, a copy of the instructions of physical verification of inventories.
	Existence, Rights & Obligations		• Determine the location of significant inventories and discuss the timing and method of inventory verification (e.g. physical count, reliance on perpetual records, confirmation with third parties etc.) with the entity. Assess the adequacy of the methods to be used. If there are multiple locations, determine those at which inventories will be observed and test counts performed. If some of the locations are to be attended by other offices, ensure

			that adequate instructions have been mailed to these offices.
	Existence		• Determine that management has verified inventories at reasonable periods and whether any significant discrepancies have been noted on such verification.
		2	On the date of physical verification, perform test counts of inventories and:
	Existence, Rights & Obligations		• Make a selection of items from the entity's count records (e.g. perpetual records, count tags) and perform test counts. Resolve discrepancies promptly based on supporting documents and/or recounts of the items, and note the disposition of such discrepancies.
	Rights & Obligations, Existence		• Make a selection of items from the entity's stock records and perform test counts. Resolve discrepancies promptly based on supporting documents and/or recounts of the items, and note the disposition of such discrepancies.
	Rights &		• Determine that the

	Obligations, Existence		count records contain sufficient details to enable us to subsequently trace to final inventory sheets.
	Rights & Obligations, Existence Completeness		• Make a selection of items from the count sheets and trace quantities to stock records and vice versa.
	Rights & Obligations, Existence Completeness		• Make a selection of inventory items from the floor and trace quantities to the entity's count records.
	Rights & Obligations, Existence		• Determine that work in progress relate to current jobs.
		3	If it is not practicable to observe inventories owned by the entity but held by others, consider whether alternative audit procedures provide sufficient appropriate audit evidence of the existence and condition to conclude that no reference needs to be made in the audit report to a scope limitation.
	Rights & Obligations, Existence		• Prepare, or have the entity prepare, confirmation requests. The requests should ask for confirmation of quantities held, the condition of the inventories, and whether they are free from lien or charge.

	Rights & Obligations, Existence		• Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the entity) and request that all replies be sent directly to the auditor's office.
		4	If inventories in the hands of public warehouses or other outside custodians represent a significant proportion of current or total assets, obtain reasonable assurance with respect to their existence by applying one or more of the following audit procedures as considered necessary in the circumstances:
	Rights & Obligations, Existence		• Obtain an independent accountant's report on the warehouseman's control procedures relevant to custody of goods or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the

			warehouseman is reliable.
	Rights & Obligations, Existence		• Observe physical counts of the goods, if practicable and reasonable.
	Rights & Obligations, Existence		• If warehouse receipts were pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate).
	Rights & Obligations	5	On the date of physical observation, ascertain that items not owned by the entity (e.g. stock on consignment from suppliers) are identified and excluded from the count of entity-owned inventories. Perform test counts, and obtain independent confirmation of significant items.
	Rights & Obligations, Existence	6	If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, take or observe some physical counts on an alternate date and if, necessary perform audit procedures on intervening transactions (see Steps 7 through 13).
		7	On the date of physical inventory verification observation, tour the entity's facilities and based on inquiry and

			observation, note the following:
	Rights & Obligations, Existence, Completeness		• Whether the inventory is arranged in an orderly manner to facilitate an accurate count.
	Existence, Valuation & Allocation		• The existence of any defective, obsolete, or unsaleable items.
	Rights & Obligations, Existence		• The treatment of inventory at or near the shipping and receiving areas, as well as inventories held but not owned, or any other inventories for which ownership is in question.
	Completeness	8	Determine that all items have been counted by the entity and have been tagged or listed on count sheets.
	Completeness, Existence	9	Determine that appropriate procedures were performed to prevent double counting or not counting any inventory and to resolve any count discrepancies. • Obtain a list of goods sold but not despatched. Ensure that this is excluded from the inventory to be valued as at the period end. • Ensure that machinery spares

			already capitalized are not included again in inventory.
	-	10	Obtain a record of inventory count documents used and unused.
	Valuation & Allocation	11	Determine that the entity has maintained proper records of its inventories and discrepancies noted between the physical stocks and the book stocks have been properly dealt with in the books of account.
		12	On the date of observation, obtain copies or note the details of the following documents, and determine whether the items included in them were excluded from or included in the physical count:
	Completeness, Rights & Obligations,		• The latest receiving documents (for purchases and sales returns) prepared before the count.
	Completeness, Rights & Obligations,		• The latest shipping documents (for sales and purchase returns) prepared before the count.
	Completeness, Rights & Obligations,		• If available, the first receiving and/or shipping documents prepared after the count.
		13	Evaluate results of the tests.

		E	**Test book to physical adjustments**
	Existence, Rights & Obligations Completeness	1	If the entity does not perform an annual physical count of each item of inventory, perform procedures to confirm that the entity's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year.
	Valuation & Allocation	2	Review book to physical adjustments made as a result of either a complete physical count at an interim date or cycle counts.
	Valuation & Allocation	3	Consider the nature and amounts of the adjustments, and management's explanation for significant adjustments. If cycle counts were used:
	Existence, Rights & Obligations Completeness		• Assess the adequacy of management's policies concerning the frequency and scope of cycle counts. Determine that the frequency and the scope of the cycle counts were in accordance with management's stated policies.
	Existence, Rights & Obligations		• Assess whether there is a basis for relying on the perpetual

	Completeness		records at year end.
	Existence, Rights & Obligations Completeness Valuation & Allocation	4	If there are no perpetual records or such records are not reconciled to the general ledger, and if the cost of inventories at year end is determined based on a 'roll-forward' of purchase and cost of sales transactions since the interim adjustments to physical, assess the reasonableness of management's methods for computing costs of sales in the intervening period from the interim count date to year end.
	Existence, Rights & Obligations, Completeness, Valuation & Allocation	5	If the magnitude and trend of book to physical adjustments indicate that there is a specific significant risk that year end balances in inventory accounts will be misstated unless a physical inventory is taken on or near the balance sheet date, then either:
			• Discuss with management the need for a year-end inventory count; or
			• If reliable perpetual records exist and are reconciled to the general ledger, perform additional test counts at or after year end to obtain assurance that

			quantities in such records are reasonably accurate.
		6	Evaluate results of the tests.
		F	**Roll Forward Test for Inventories Price Tested prior to year end**
	-	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on inventory balances.
	Completeness, Valuation & Allocation	2	Perform substantive analytical procedures to test inventory balances at the year-end. Consider using the following data, as applicable, to develop an expectation of inventory balances at the year-end:
			• Prior period balances.
			• Monthly amounts of cost of sales and purchases in the intervening period from the date at which inventory cost was tested to the balance sheet date compared to such monthly amounts in prior years and in the current year prior to the interim testing date.
			• Trends in book to physical adjustments made in the current year and prior years.

			• Trends in sales, cost of sales, and gross margins.
			• Reconciliation of specific account balances in the intervening period.
	Completeness, Valuation & Allocation	3	Determine that the data used to make independent estimates is independent and reliable and if information produced by the entity is being used, obtain audit evidence about the accuracy and completeness of the data.
	Completeness, Valuation & Allocation	4	If the data is not independent, separately audit the data. In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was granted.
	-	5	Determine the threshold – the amount that represents the maximum difference between the expectations and recorded year-end inventory balances that is acceptable without further investigation.
	-	6	Compare the expectation to the recorded balance and identify any differences. For any difference, that is more than the threshold, obtain, quantify, and corroborate explanations for the

			difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
	Existence, Rights & Obligations Completeness Valuation & Allocation	7	Consider investigating the following:
			• Any unusual pattern in the differences.
			• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether such considerations give rise to any specific or pervasive risk as a result of fraud risks.
		8	Test transactions during the intervening period between the date at which inventory cost was tested and year end:
	Completeness		• Obtain a reconciliation of the interim inventory

			balances to the year end balances.
	Completeness		• Agree purchases totals to purchase journals.
	Valuation & Allocation, Rights & Obligations, Existence		• Examine supporting documents to verify other significant entries.
		9	Make a selection of entries to purchase journals in the intervening period between the interim testing date and year end and trace the selected entries to purchase invoices and receiving records.
	Valuation & Allocation, Rights & Obligations		• Verify additions and extensions on the invoices.
	Cut Off		• Determine that the purchases were recorded in the correct period.
		10	Evaluate results of the tests.
		G	**Test the Final Inventory Compilation**
		1	Obtain the final, priced inventory compilation and perform the following (the compilation should reflect the quantities counted at the physical observation date):
	Valuation & Allocation, Rights & Obligations,		• Test the summarization and reconciliation of the total to the general

	Completeness			ledger and trace significant reconciling items, if any, to supporting documentation.
	Completeness		•	Trace quantities of items test counted or confirmed by us on the physical verification date to the compilation. Reconcile any discrepancies based on supporting documents.
	Completeness Rights & Obligations		•	For sites visited by us compare the compilation to the record of count documents obtained on the physical observation date. Obtain and corroborate explanations for any added items.
	Valuation & Allocation		•	Review the compilation for unusual or negative balance items or costs. Obtain and corroborate explanations for any such items.
	Valuation & Allocation		•	Obtain or prepare a list of the highest items by quantity and value for the current and prior year. Investigate the reasons for any

			significant differences.
	Valuation & Allocation, Rights & Obligations		• Where goods have been delivered to customers on consignment or sale or return basis, determine that such goods have been included in the compilation and excluded from receivables.
		2	Using the cut-off documents obtained during the inventory count, along with related vouchers, purchase invoices, sales invoices, debit notes, credit notes and goods inward notes perform the following:
	Completeness, Cut Off		• Verify that the following items included in the physical inventory count were also included in the compilation:
			* Goods received prior to the count for which a purchase or credit note was recorded on or before the count date.
			* Goods shipped subsequent to the count for which a sale or debit note was recorded after

			the count date. * All sales returns from customers which have been received or credit notes have been issued prior to period end.
	Completeness, Cut Off		• Verify that the following items excluded from the physical inventory count were also excluded from the compilation:
			* Goods shipped prior to the count for which a sale or debit note was recorded on or before the count date.
			* Goods received subsequent to the count for which a purchase or credit note was recorded after the count date.
		3	Make a selection of items from the final, priced inventory compilation and perform the following:
	Completeness Valuation & Allocation		• Trace the quantities to the original count documents.
	Valuation & Allocation		• Test the extension of quantities and unit costs.
			• Obtain an understanding of the

			elements that make up the unit costs of inventory.
	Valuation & Allocation		⁎ Verify unit costs by examining the most recent purchase invoices showing quantities equal to the quantities used to determine final FIFO costs, and recompute the costs (in case FIFO is followed).
	Valuation & Allocation		⁎ Verify that unit costs are based on purchase invoices and not supplier's price lists.
	Valuation & Allocation		⁎ Verify that unit costs are adjusted for trade discounts, rebates, other price reductions and inter-unit unrealized profits have been properly eliminated.
	Valuation & Allocation		⁎ Verify that the unit cost includes: - Acquisition and production costs. - Freight, duty and other related costs where material.

	Valuation & Allocation		- Overhead expenses that are clearly related to inventory production. - Any price revisions which have been agreed with the suppliers. * Verify that the unit. costs excludes: - Selling expenses. - Abnormal freight. - Abnormal handling costs. - Amounts of wasted materials (spoilage). - Claims recoverable from various authorities in respect of expenses that are not debited to the profit & loss account. - Generally, general and administrative expenses, except for the portion of such expenses that are clearly related to

			inventory production.
	Valuation & Allocation Rights & Obligations		• Verify that items such as abnormal freight, abnormal handling costs and amounts of wasted materials (spoilage) are treated as current period charges by agreeing the amounts to the appropriate general ledger accounts.
	Valuation & Allocation		• Ensure that excise duty has been accrued as a liability and included in the valuation of finished stock.
	Valuation & Allocation		• If the entity has changed the composition of the elements of costs from the prior year, such a change is an accounting policy change. If such a change has occurred, perform the following:
			∗ Verify that excise duty and sales tax set off is not included in valuation of raw materials and stores and spares if cenvat credit and sales tax set off has been credited to purchases.
			∗ Obtain

			documentation supporting management's justification for the change in composition of the elements of cost.
			* Determine that the change in the composition of the elements of cost represents a preferable change. (Prefer ability is determined on the basis of whether the new principle constitutes an improvement in financial reporting).
			* Determine if the entity appropriately accounted for the change in the composition of cost.
	Completeness Rights & Obligations Existence	4	If the book to physical adjustments is significant, inquire whether any unexplained shortage of physical stock represents unrecorded sales or whether any unexplained excess of physical stock represents unrecorded purchases.
		5	Evaluate results of the tests.
		H	**Test Inventory Aging**

	Valuation & Allocation, Completeness	1	Obtain the inventory aging, and the reconciliation of the inventory aging to the general ledger and/or stock ledger. Agree applicable amounts from the inventory aging and reconciliation to the general ledger and trace significant reconciling items, if any, to supporting documents.
	Valuation & Allocation	2	Using the selections made at G.3, test the accuracy of the inventory aging by tracing invoice details for the price testing selections to the inventory aging for proper categorization within the aging buckets.
	Valuation & Allocation	3	Determine that the percentages of inventory by each aging category (and department, if applicable) to total inventory are consistent and comparable with prior periods and/or industry metrics.
	Valuation & Allocation	4 5	Determine that the accounting policies and procedures for developing the inventory aging are appropriate and are applied consistently. Review changes in the aging categories during the period and consider their reasonableness in view of prior history and current information.

			Review the aged items of inventory and ensure whether these pertain to products of the Company which are still being sold. Ensure adequacy of provision, if required.
		6	In the case of machinery spares, these are generally consumed over a longer period of time as compared to other inventory. Ensure adequate provision is made for such inventory Obtain a list of obsolete inventory as per technical evaluation done by the Company. Ensure adequate provision is made.
		7	Evaluate results of the tests.
		I	**Test late cut-off of inventory purchases**
	Cut Off	1	Make a selection of recorded inventory purchases in the **five (5)** day period prior to the year-end and trace selected purchase invoices to receiving reports. Determine that the purchases were recorded in inventory in the correct period.
	Cut Off	2	Make a selection of initial records of receipts of goods that occurred in the **five (5)** day period after

			the year-end and trace selected receiving records to purchase invoices. Determine that the purchases were recorded in inventory in the correct period.
		3	Evaluate results of the tests.
		J	**Test early cut-off of debit notes**
	Cut Off	1	Inquire into returns to vendors in the **five (5)** day period prior to the year-end. Determine that the debit notes were recorded as credits to inventory in the correct period.
	Cut Off	2	Make a selection of recorded debit notes in the **five (5)** day period after the year-end and trace the debit notes to shipping records. Determine that they were recorded as credits to inventory in the correct period.
	Cut Off	3	Review miscellaneous credits to inventory accounts recorded in the **five (5)** day period after year end. Trace the credits to supporting documents and determine that they were recorded in the correct period.
		4	Evaluate results of the tests.
		K	**Goods in Transit**
		1	If goods in transit are included in inventory,

			perform the following:
	Rights & Obligations, Existence		• Trace amounts to supplier's invoice and dispatch documents.
	Rights & Obligations, Existence		• Determine that the items were received shortly after the year end date.
	Completeness, Cut Off		• Check that the invoices have been included in creditors.
	Completeness, Cut Off	2	If goods in transit include transfers from other locations of the entity, determine that these goods have been excluded from the inventory of that other location.
		L	**Test provision for inventory**
	Valuation & Allocation	1	Inventory should be stated at the lower of cost or and net realizable value, Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a

			decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.
	Completeness	2	Obtain a schedule of provision for inventory showing beginning and ending balances, write-offs, and provisions. Test the summarization of the schedule and trace the ending balance and the amount of the current year provision to the general ledger.
	Valuation & Allocation	3	Evaluate the reasonableness of the methods and assumptions management used to estimate the provision.
	Valuation & Allocation	4	If net realizable value is lower than cost, and management has not provided for this, determine if the exception in Step L.1 exists.
	Valuation & Allocation	5	If management's methods and assumptions were reasonable, test the data and assumptions underlying the estimate, and recompute the

			estimate.
	Valuation & Allocation	6	If management's methods and assumptions were NOT reasonable, develop an independent range of reasonable estimates and determine whether the management's estimate falls within that range. Consider the following factors, as applicable, in developing an independent range of reasonable estimates: • Market value of specific items that are obsolete or defective. • Held in quantities excessive in relation to demand, or devalued • Inventory turnover. • Trend in gross margins. • Trend in sales. • Trend in quantities on hand. • Disposition of prior year obsolete items. • Ratio of inventory to assets. • Large capitalized variances. • Purchase or sales commitments.
	Completeness, Valuation & ~~Accuracy~~ Allocation	7	Determine that the data used to make independent estimate is independent and reliable and if information produced by the entity is being used, obtain audit evidence

			about the accuracy and completeness of the data.
	Valuation & Allocation	8	If the data is not independent, separately audit the data. In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was granted.
	Valuation & Allocation	9	Determine that any defective, obsolete, or unsaleable inventories noted during the physical observation have been appropriately considered and written down.
	Valuation & Allocation	10	Inquire as to whether any sales incentives have been offered that will result in a loss on sale of the product (e.g. hold discussions with entity personnel outside the accounting department). Determine that inventory related to such products has been evaluated for impairment and was separately written down or appropriately considered by performing the following:
			• If the inventory has been separately written down, obtain management's impairment analysis and evaluate the reasonableness of the

			methods and assumptions used to determine the impairment loss. If management's methods and assumptions were reasonable, test the data and assumptions underlying the impairment analysis, and recompute the impairment loss.
		11	Evaluate results of the tests.
		M	**Test Allocations of Labour and Overhead**
	Valuation & Allocation	1	Obtain the entity's computation of allocation of labour and overhead to specific items of inventory or to the inventory as a whole when standard costing is not used. Assess the reasonableness of management's allocation of methods and assumptions.
	Valuation & Allocation	2	For allocation of labour and overhead to specific items of inventory (e.g. those items selected under Section G.3) or to the inventory as a whole:
			• Trace labour rates and production hours to supporting documents (e.g. union contracts, production records).

			• Determine that the bases for allocating various types of overhead expenses are reasonable. Trace key amounts shown in the computations to general ledger balances and other supporting documents.
			• Recompute the extensions and additions of labour and overhead allocations.
	Valuation & Allocation	3	Determine if the entity's allocation of fixed production overheads were based on the normal capacity of the production facilities by performing the following:
			• Inquire as to the entity's policy for determining when the production level of inventory is considered normal, abnormally high, abnormally low or if a plant is considered idle plant.
			• For those periods in which production was determined to be abnormally high, abnormally low or if a plant was considered idle, obtain documentation

			supporting that assessment.
			• Determine that for instances in which the production level was considered abnormally high, that the amount of fixed overhead allocated to each unit of production was not decreased.
			• Determine that for instances in which the production level was considered abnormally low or the plant was considered idle that the amount of fixed overhead allocated to each unit of production was not increased.
			• Verify that unallocated overheads were recognized as expense in the period in which the costs were incurred by agreeing the amounts to the appropriate general ledger account.
		4	Evaluate results of the tests.
		N	**Test Elimination of Inter-Divisional Profit**
		1	Obtain a schedule of the entity's computations of inter-divisional profit elimination. Perform the

			following:
	Valuation & Allocation, Completeness		• Review inter-divisional accounts and the prior year calculation of the elimination of inter-divisional profit in inventory accounts. Determine that the schedule is complete and that the calculation method is consistent with that used in the prior year.
	Valuation & Allocation,		• Trace significant amounts in the schedule to the final inventory compilation and other supporting documents.
	Valuation & Allocation		• Recompute the inter-divisional profit and trace the amount to the general ledger.
		O	**Test Standard Costs**
	Valuation & Allocation	1	Ascertain and determine the entity's process for establishing standard costs. Specifically determine:
			• Which products and inventory items are valued using standard costing.
			• How frequently costs are revised.
			• Whether the basis of calculating standard costs is consistent with the basis used in prior years.
			• What cost data is

			used to set standards.
			• What other factors are considered in building the standards (e.g. inflation, capacity level, efficiency targets).
			• How price and volume variances from standard costs are recorded in the accounting records.
			• What review procedures are followed to identify variances which should be excluded from the inventory valuation (e.g. excess material usage, labour stoppages etc).
	Valuation & Allocation	2	Make a selection of inventory items (see Section G.3). For each item selected, verify:
			• If there have been no significant changes in the entity's business, and the prior year standard costing methodology was deemed reasonable and reliable, compare the current year standard cost to the prior year standard cost. Discuss significant differences with management.
			• Verify materials standard cost using

			recent purchase invoices and material quantities to bills of material and product specifications.
			• Review labour and overhead components of standard cost for reasonableness considering the entity's basis for allocation.
			• Determine whether assumptions used to take account of normal wastage, operating capacity etc. are reasonable.
	Valuation & Allocation	3	Review the standard cost file (or request the entity to run an edit report) to identify unusual relationships such as: • Overhead cost with no labour cost. • Labour or overhead cost with no material cost. • Current year standard cost significantly greater than prior year standard cost.
	Valuation & Allocation	4	Verify that the entity has updated its standard cost file on a basis that is consistent within the industry in which it operates, and assess the timing of the update for reasonableness. If standard costs have not

			changed during the year:
			• Check variance adjustments to inventories and consider whether an acceptable valuation can be achieved by use of old standards.
			• Trace standards from prior year's working papers to standard prices used to value current year's inventories.
			• For new products for which new standards have been set, test the cost data used in setting these standards.
	Valuation & Allocation	5	Determine the reasonableness of the levels of production upon which standards are based in the light of 'normal capacity'. Consider the effect where actual production is significantly above or below the levels used is setting the standards.
	Valuation & Allocation	6	If standards have been changed after the balance sheet date, review the standards used at the balance sheet date for valuation of inventories with the new standard and investigate for any large or unusual fluctuations.
	Valuation &	7	Make a selection of

	Allocation		purchase and wage transactions during the year and check the amounts recorded to the variance accounts by calculating the difference between standard costs and the actual cost of goods and services purchased and labour.
	Valuation & Allocation	8	Review variance accounts for the entire year for unusual entries and investigate such entries.
		9	Evaluate results of the tests.
		P	**Test presentation of inventory**
	-	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on inventory.
	Classification & Understand-ability, Accuracy & Valuation, Completeness, Occurrence & rights and obligations	2	Determine that amounts presented as inventory are properly recorded, classified and/or disclosed as required by the Revised Schedule VI of the Companies Act and other accounting pronouncements: • Inventories should be classified as: ∗ Raw materials; ∗ Work-in-progress; ∗ Finished goods; ∗ Stock-in-trade (in respect of goods acquired for

			trading); * Stores and spares; * Loose tools; * Others (specify nature). • Goods-in-transit should be disclosed under the relevant sub-head of inventories. • Mode of valuation should be stated. • the accounting policies adopted in measuring inventories including the cost formula used should be disclosed. • the total carrying amount of inventories and its classification appropriate to the enterprise should be disclosed. • Provision for diminution in the value of inventories. • Inventories pledged or assigned. • Significant purchase commitments or other contingencies. • Inventories not held for sale.
		Q	**Conclusion**
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.

	-	2	Consider including the following when documenting the conclusion: • A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. • The relevant potential errors and control objectives for each account balance or disclosure being tested. • The substantive procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors. • The results of substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure. • The tests of controls performed or a cross reference to where the tests of controls

			performed are documented. • The results of tests of controls, including deficiencies identified, and how such results support the conclusion as to whether control reliance has been obtained for the potential errors for each account balance or disclosure.

Chapter 6
Other Assets, Loans and Advances

Non- Recoverable Tooling Advance

6.1 Generally, all the components are not manufactured by the automobile Company. It gives contracts to manufacture parts/components to be used specifically in the production of a particular vehicle to other vendors. The Company gives an advance (non-recoverable) to these vendors for the purchase of capital assets (machines) in order to manufacture these parts/components. Such advances could be a means of financing the vendor and should be accounted for as per the agreement between the management and vendor.

6.2 The auditor should review the agreement entered into with the vendor to establish whether the capital assets belongs to the Company or to the vendor. If the capital asset belongs to the Company, it should be capitalized and written off during the period as set out in the agreement. However, if such component becomes out dated due to change in technology or the Company has stopped taking supply of such component, the Company should write off the remaining balance of advance immediately. If the capital asset does not belong to the Company, the advance should be expensed off.

Service Tax Credit Recoverable Account

6.3 Service tax paid for the services availed is debited to this account. The auditor should review this account with the objective of determining whether or not the entire balance can be utilized as a credit against the service tax liability. The auditor should also verify whether the credit can be taken and whether service tax has

been utilized according to the service tax rules. For example, if the invoices are not complete or are defective or certain entries in the invoices are not legible, the Company may not be able to claim the input credit. In such cases, the auditor may consider whether such balances should be written off.

Prepaid Expenses

6.4 The auditor should verify the prepaid expenses in the same manner as followed in other industries. Therefore, the auditor should examine whether the basis of the allocation of expenditure to different periods is reasonable. Expenses such as insurance premiums, advance rent, discounting charges are examples of some expenses that are paid in advance.

Interest Receivable

6.5 This includes interest accrued on bank deposits, employee loans and advances. The auditor should verify the same in a manner similar to that followed in any other industry.

6.6 The auditor should ensure that interest income is recognized accurately in the books of account by verifying the principal amount, the rate of interest and the period of loan.

Advance to Suppliers for Materials, Expenses and Capital Goods

6.7 Advances given to the suppliers for plant and machinery, vehicles, building material, are included under the advance for capital goods. Other capital advances will include advances for leasehold improvements, electrical equipments like UPS, DG sets, security systems, office equipments, furniture and fittings, etc.

6.8 Similarly advances for materials and expenses may include advances towards repairs and maintenance, purchase of items of spares and stores, advertising costs, etc. The auditor should review these balances in a manner similar to that followed in other industries.

6.9 Due to inappropriate flow of information, the liability and advance accounts may both be inflated. The auditor should verify that proper provisioning of such expenses is done in the books of account and verify that the liability is netted off with the appropriate advance account. Such errors generally occur in a non-ERP based environment. The auditor should, however, review the balances in advance accounts to ensure that they include only actual advances.

6.10 All of the above advances may be audited in a manner similar to that followed in the case of any other industries by verifying the nature of advances, the agreement terms, policy, approvals, aging and recoverability. Capital advances should be shown under the head 'Long term Loans and Advances' as per the requirements of Revised Schedule VI.

Security Deposits

6.11 Security deposits with various government authorities (e.g., on account of telephone, electricity, tax, customs, excise etc.) and with others (e.g., deposits in respect of premises taken on rent) should be checked with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. The auditor should ensure that the agreement against which a security deposit has been given is still valid and the amount is recoverable from the party.

Balance with Excise Authorities

6.12 This account represents the various account balances standing in the books with the various government authorities such as Excise, VAT, Entry Tax etc. The auditor should verify the amount standing in the excise returns and VAT returns filed by the Company with the various Government Authorities. The auditor should verify that the net debit balances pending adjustment/recovery should be disclosed in this account.

Other Items

6.13 Other items that are generally included under current assets are as follows:

- Salary advances.
- Employee loans.
- Inter-company balances.
- Advance tax and TDS recoverable.
- Any other amounts receivable from government.

The auditor should follow the usual audit procedures for all such account balances.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material misstatement

6.14 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering "what can go wrong" for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

6.15 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor's cumulative knowledge of the entity.

6.16 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

6.17 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity's controls, including control activities, relevant to that risk.

6.18 Hence, these audit procedures will vary according to the given situation.

Loans, Advances and Other Assets

Material Classes of Transactions, Account Balances and Disclosures	Assertions		Audit Procedures
Loans, Advances and Other Assets		**A**	**System update**
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	**Recording accuracy**
	Completeness	1	Obtain/prepare a schedule of all loans and advances and other current assets. Test the total and the reconciliation of the total to: • Trial balance. • General ledger. • Balance sheet.
	Completeness	2	Obtain/prepare a schedule under the following main headings and agree the total to the trial balance and general ledger. • Capital advances. • Advances to suppliers. • Other advances. • Balances with Customs, Central Excise, Port Trust, etc. • Tax deducted at source and advance payment of tax. • Bills of exchange.

			• Staff advances/loans. • Loans given to companies and other entities. • Security and other deposits. • Prepaid expenses.
		C	**Review of balances**
	Valuation & Allocation, Completeness	1	Review and explain movements between current year, prior year and budgeted amounts for: • individual type and aggregate advances by location, type, staff cadre, ageing. • aggregate and individual prepaid expenses. • aggregate and individual other asset balances. • Provision for doubtful advances and deposits.
	Existence, Valuation & Obligation, Rights & Obligations	2	Investigate for any journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements at the year-end and test the appropriateness of such entries.
	Valuation & Allocation	3	Review entries in respective ledger accounts for the year for significant credit balances and check for any misstatements.
	Valuation & Allocation, Rights & Obligations	4	Review entries in respective ledger accounts for the year and investigate for any large or unusual items.
		D	**Confirm loans and advances**

	Existence, Rights & Obligations, Completeness, Valuation & Allocation	1	Prepare, or have the entity prepare, confirmation requests for the balances selected. On the confirmation, consider including outstanding balance and a statement of accounts.
			• Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the client) and request that all replies be sent directly to the auditor's office.
			• Send second request for non-replies. Request the entity to follow up, if necessary.
			• Compare replies to requests. Prepare, or have the entity prepare, reconciliation of exceptions. Trace reconciling items to supporting documents.
			• Inquire into any significant disputed balances. Investigate as necessary.
	Rights & Obligations, Valuation & Allocation	2	If tests of details include examination of supporting documentation for which a document cannot be located and no other acceptable

			alternative evidence can be found, consider the selected items to have misstatements equal to the book value of the unsupported amounts.
	Rights & Obligations, Valuation & Allocation	3	If the misstatements of the unexamined documents would lead us to conclude the account balance or disclosure contains material misstatement, consider performing alternative procedures that will provide us with sufficient appropriate audit evidence to form a conclusion on the account balance or disclosure.
		4	Evaluate results of the tests.
		E	**Test advances to suppliers**
	Completeness, Rights & Obligations, Valuation & Allocation	1	Obtain the schedule of advances to suppliers and agree the totals to the general ledger. Trace significant reconciling items, if any, to supporting documents.
	Valuation & Allocation	2	Agree selected individual balances to suppliers' ledger account.
		3	Make a selection of significant advances and perform the following:
	Completeness, Rights & Obligations, Valuation & Allocation		• Determine reasons for such advances. • Investigate their recoverability. • Investigate reasons for delays, if any, in adjusting balances. • Verify subsequent realizations/adjustments. • Agree advances paid to

			terms stated in purchase orders and other supporting documents. • If any interest is chargeable on these advances, ensure that this has been collected and accounted for. • Verify if any of the advances paid appear to be in the nature of loans.
	Completeness, Valuation & Allocation	4	Make a selection of balances from the schedule of advance to suppliers and trace the balances to subsequent adjustments or cash receipt records. Trace unpaid/unadjusted balances to vendor correspondence, if any.
		5	Evaluate results of the tests.
		F	**Test Loans and advances**
	Completeness, Rights & Obligations, Valuation & Allocation	1	Obtain a schedule of the following loans and advances and agree the totals to the general ledger. Trace significant reconciling items, if any, to supporting documents: • staff loans and advances. • loans to companies. • loans to other entities.
	Rights & Obligations, Valuation & Allocation	2	Review the terms and conditions of all loans granted to entities listed in the register maintained under Section 301 of the Companies Act, 1956 and verify that these are not prejudicial to the interests of the entity with regard to comparative terms for: • security offered.

			• rate of interest. • terms of repayment. • other conditions attached.
	Valuation & Allocation	3	If the terms and conditions of any loan appear to be prima facie prejudicial to the interests of the entity, obtain written explanation from management as to why it should not be so considered in the audit report.
	Valuation & Allocation	4	Inquire if the stipulations regarding payment of interest and principal have been followed and if not what steps have been taken to ensure compliance.
	Existence, Rights & Obligations, Valuation & Allocation	5	For significant balances ensure that: • the staff to whom such loans have been given are in the service of the Company. • recoveries are made on a regular basis as mentioned in the stated terms. • interest, if receivable, has been accounted.
	Rights & Obligations, Valuation & Allocation	6	Check compliance of sections 77, 292, 295, 370, 372A of the Companies Act.
		7	Evaluate results of the tests.
		G	**Test Other advances**
	Completeness, Rights & Obligations, Valuation & Allocation	1	Obtain the schedule of other advances and agree the totals to the trial balance and general ledger. Trace significant reconciling items, if

			any, to supporting documents.
	Valuation & Allocation	2	Verify if any balances are in the nature of loans.
	Valuation & Allocation	3	Review major balances and identify amounts that are overdue. Trace such balances to subsequent cash receipts and to vendor correspondence, if any.
	Completeness, Rights & Obligations, Valuation & Allocation	4	Make a selection of deposits and determine the conditions under which such deposits were made and the need for existence of such deposits. Trace the individual deposits to deposit receipts and other correspondence, if any, and verify whether interest if applicable, has been collected and accounted.
		5	Evaluate results of the tests.
		H	**Test Prepaid Expense Balances**
	Rights & Obligations, Valuation & Allocation	1	Review the information in prior year working papers and/or inquire concerning the nature of each significant prepaid expense account and the policies and procedures used to account for them.
	Rights & Obligations, Valuation & Allocation	2	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on prepaid expense balances.
	Valuation & Allocation	3	Inquire as to the reasons for significant changes in prepaid expense balances since the prior year.
	Valuation &	4	Determine that the accounting

	Allocation		policies and procedures for setting up prepaid expenses as assets and for amortizing them to expense are appropriate and are applied consistently.
	Rights & Obligations, Valuation & Allocation	5	In the course of performing procedures for prepaid balances, consider whether the audit evidence supports the understanding of prepaid expense accounting policies and procedures and their propriety.
	Completeness, Rights & Obligations, Valuation & Allocation	6	Perform substantive analytical procedures to test prepaid expense balances. Consider using the following data, as applicable, to develop an expectation of significant prepaid balances at the year-end:
			• balances of prepaid expenses in prior years (e.g. balances at the prior year end). • balances at preceding dates in the current year. • prior and current year expenditures, amortization to expense, and their timing.
	Valuation & Allocation	7	Determine that the data used to make independent estimates is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation &	8	In assessing the reliability of

	Allocation		the data gathered, consider the source of the data and the conditions under which it was gathered.
	-	9	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded prepaid expense amounts that is acceptable without further investigation.
	-	10	Compare the expectation to the recorded balance and identify any differences. For any difference that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
	Valuation & Allocation	11	Also consider investigating the following:
			• Any unusual pattern in the differences.
			• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or

			pervasive risk as a result of fraud risks.
	Completeness, Rights & Obligations, Valuation & Allocation	12	Make a selection of recorded prepaid expense balances and perform the following:
			• Obtain a roll-forward schedule showing the beginning and ending balances, additions, and amortization expense.
			• Investigate any large or unusual items.
	Rights & Obligations, Valuation & Allocation	13	Make a selection of the recorded additions and trace them to supporting documents. (e.g. invoices and evidence of the period over which the expense is recognized)
			• Recompute the amortization to expense and determine that expectations of future benefits are reasonable.
		14	Evaluate results of the tests.
		I	**Test Accrued income**
		1	*Income accrued on investments is to be tested along with investments. Such amounts are disclosed as other current assets.*
	Rights & Obligations, Valuation & Allocation	2	Make a selection from subsidiary records of accrued income and test such income by examining subsequent receipts or testing the accrual using records supporting the amounts and the selected accruals.

	Completeness	3	Agree total of other accrued income to the general ledger.
	Rights & Obligations, Valuation & Allocation	4	Test the calculation of other accrued income. Assess and, if necessary, test, the accuracy of the supporting data. Recompute the estimates.
		J	**Test provision for doubtful advances/deposits write off**
	Valuation & Allocation	1	Determine that the accounting policies and procedures for estimating and recording provisions for doubtful advances/ deposits and advances write off are appropriate and consistently applied.
	Completeness	2	Obtain a schedule of the provision for doubtful advances/ deposits showing opening and closing balances, write-offs and recoveries. Trace the closing balance and the amount of advance write off to the general ledger and trial balance.
	Rights & Obligations, Valuation & Allocation	3	Check that advance write offs and provision for doubtful advances/deposits has been included in the draft resolution to be considered by the board of directors along with the adoption of accounts.
	Valuation & Allocation	4	Make a selection of advance write-offs recorded in the general ledger and review documents and correspondence supporting uncollectability and determine that the write-offs were

			authorized.
	Valuation & Allocation	5	Evaluate the reasonableness of the methods and assumptions management used to estimate the provision for doubtful advances/deposits and whether the methods for calculating such provisions are applied consistently.
	Valuation & Allocation	6	If management's methods and assumptions were reasonable test the data and assumptions underlying the estimate, and recompute the estimate. Compare, where possible, estimates made in prior periods with the actual results of those periods and consider management's or the directors' review and approval procedures.
	Valuation & Allocation	7	If management's methods and assumptions were NOT reasonable, develop an independent range of reasonable estimates and determine whether the management's estimate falls within that range. Consider the following factors, as applicable, in developing an independent range of reasonable estimates:
			• Collectability of significant overdue accounts. • Collectability of large advances. • Collections, write-offs and recoveries after year

			end. • Collections, write-offs and recoveries during the year and in the prior years. Discuss the results with the management.
	Completeness, Valuation & Allocation	8	Determine that the data used to make independent estimates is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation	9	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	Rights & Obligations, Valuation & Allocation	10	Where advances have been given to subsidiaries or to related parties, review net worth of such entities from the latest financial results. Examine need for provision against such balances.
	Valuation & Allocation	11	Prepare a list of advances which in the auditor's opinion are doubtful of recovery with reasons and discuss the same with the management.
		12	Evaluate results of the tests.
		K	**Test Balances Denominated in Foreign Currencies**
	Completeness	1	Inquire and consider other available evidence, if any, to identify transactions in foreign currency.
	Valuation & Allocation	2	Agree the closing rate(s) used to published records and test

			the translation calculation wherever the items are monetary items as defined in AS 11.
	Valuation & Allocation	3	Trace currency translation adjustments to the general ledger.
		L	**Test Presentation of Loans and Advances**
	Classification & Understandability, Accuracy & Valuation	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on loans and advances.

	Classification & Understand-ability, Accuracy & Valuation, Completeness, Occurrence & rights and obligations	2	Determine that amounts presented as loans and advances are properly recorded, classified and/or disclosed as required by Schedule VI to the Companies Act:
			• Advances and loans to subsidiaries.
			• Advances and loans to partnership firms in which the Company or any of its subsidiaries is a partner.
			• Bills of exchange.
			• Advances recoverable in cash or in kind or for value to be received.
			• Balances with customs, port trust etc.
			• Above items need to be further classified into:
			  * Considered good and in respect of which the Company is fully secured.
			  * Considered good for

			which the Company holds no security other than the debtor's personal security. * Considered doubtful or bad. • Due by directors or other officers of the Company. • Where a guarantee has been furnished in respect of a debt without the backing of tangible security, it should be ensured that the debt is classified as unsecured. • Due by directors or other officers of the Company or any of them either severally or jointly with any other person. • Due by firms or private companies respectively in which any director is a partner or a director or a member. • Due from other companies under the same management [section 370(1B)] with the names of the companies. • The maximum amount due by directors or other officers of the Company at any time during the year.
	Accuracy & Valuation	3	The provision for doubtful advances should not exceed the amount stated to be considered doubtful or bad and any such surplus of such provision, if already created, should be shown under

			Reserves and Surplus.
	Completeness	4	Obtain a list of related party balances and determine that all identified related parties with balances at year end are included in the list.
	Classification & Understand-ability, Accuracy & Valuation, Completeness	5	Examine significant transactions together with the related documents and determine whether they are properly authorized and that the economic substance of the transactions support their recording. Trace the amounts in the list to the trial balance.
	Occurrence & rights and obligations	6	Obtain confirmation of balances.
		M	**Conclusion**
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.
	-	2	Consider including the following when documenting the conclusion: • A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. • The relevant potential errors and control objectives for each account balance or disclosure being tested. • The substantive

			procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors. • The results of the substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure. • The tests of controls we performed or a cross reference to where the tests of controls performed are documented. • The results of the tests of controls, including deficiencies identified, and how such results support the conclusion as to whether control reliance for the potential errors for each account balance or disclosure has been obtained.

Chapter 7
Current Liabilities and Provisions

7.1 Provisions and liabilities are present obligations arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. An essential characteristic of a provision or a liability is that the enterprise has a current obligation i.e. a duty or a responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or a statutory requirement. This is normally the case with, for example, amounts payable for goods and services received. However, obligations can also arise from the normal business practices, customs, and a desire to maintain good business relations or to act in an equitable manner. If, for example, an enterprise decides to rectify faults in its products, even when they become apparent after the expiry of the warranty period, the amounts that are expected to be expensed off in respect of goods already sold are provisions. Provisions and liabilities are shown separately in the balance sheet.

7.2 Provisions can be distinguished from other liabilities such as trade payables and accruals because in the measurement of provisions substantial degree of estimation is involved with regard to the future expenditure required in settlement.

Warranty

7.3 Provision for warranty is an important term in relation to the automotive industry.

7.4 Warranties and similar measures taken by a manufacturer and/or a seller are intended to protect the buyer from different types of defects in the product. This covers everything from material and assembly defects to the fact that the product does not meet its previously established standards.

7.5 Warranty can be a contractual warranty or a campaign warranty as explained below-

A. Contractual Warranty

7.6 In the automotive industry, usually every vehicle delivered from an authorized station is covered by a factory warranty in accordance with the specific conditions. This warranty is known as a contractual warranty and is provided on the sale of the product.

If specific guidance is issued to dealers to extend the cover during the warranty period for certain items and components, future related costs should be included in the provision e.g., for a particular vehicle model, warranty for engine may be extended from one year to three years.

7.7 Contractual warranty costs must be recognized on an accrual basis on the date of sale and should be computed taking into account the following:

- Period of the warranty,
- Average time lag between the sale of a product by the Company and the sale to an end-customer by the dealer,
- Average time lag between the occurrence of a fault and the time of the actual expense to the Company.

7.8 Warranty accrual should be based on warranty cost statistics and take into account anticipated changes in the quality indexes and costs. These costs should be reviewed regularly by the management.

7.9 The auditor should ensure that the provision for warranty is recognized by the Company in accordance with the contract after considering the period of warranty and historical data with respect to the old models. Actual claims received are a good indicator of the provision that may be necessary. In case of new models, provision should be recognized on the basis of estimation of expenses by the management. This estimation should be supported by reasonable and supportable assumptions.

Illustration

Background

X Auto Limited, a manufacturer of car model – Alpha, provides to its customers a warranty for any manufacturing default for a period of one year from the vehicle's sale. Assuming Alpha model was launched in the market 5 years ago.

Solution

X should recognize the provision for warranty on sale of Alpha. As assumed above, the model Alpha was launched 5 years ago. X should calculate warranty cost using the historical data and calculate warranty cost incurred for a year. Further, X should also consider anticipated changes in the quality indexes and future costs.

Audit procedures

- The terms of the warranty agreement should be checked by the auditor to ensure that all costs related to warranty have been considered.
- The historical data should be checked on test check basis to ensure its accuracy.

7.10 New product warranty costs should be estimated by using statistics for comparable existing products, taking into account anticipated changes in the quality indexes. Further, every automotive Company before launching the vehicle in the market prepares the business case model (budget) for specific vehicle models and engineers estimate the warranty cost that would be incurred for the initial years. The auditors should evaluate the assumptions in detail to ensure the accuracy of the same.

Illustration

Background

Assuming model Alpha is recently launched in the market.

Solution

X should recognize the provision for warranty on the sale of Alpha. Since the model Alpha is launched recently, there would be no historical data available with respect to the warranty cost of Alpha. Now, X should calculate warranty cost using the business case model (as explained above) and should also consider statistics for comparable existing products, taking into account the anticipated changes in the quality indexes.

Audit procedures

- The terms of the warranty agreement should be checked by the auditor to ensure that all costs related to warranty have been considered.
- The assumptions considered in the business case (budget) should be evaluated in detail.
- The comparable historical data, if available, should be checked on a test check basis to ensure the accuracy of the same.

7.11 The auditor should ensure that the estimated refunds from the suppliers ("vendor recoveries") should be recognized only when the receipt of such refunds is virtually certain. Historical statistics should be used in order to support the level of highly probable refunds. Estimated refunds should be shown separately in the balance sheet.

7.12 To the extent warranty claims are expected to be settled through the delivery of replacement parts and components, the auditor should ensure that the warranty provision is calculated on a cost basis, i.e. the provision should not cover the Company's future gross profit on the delivery of such parts and components.

B. Campaign Warranty

7.13 Campaign warranty is a warranty cover decided after the sale of the product, which generally relates to specific safety and

technical problems. In certain circumstances, the customers are officially required to bring back their vehicle for repair or testing e.g. call back of vehicles; in other cases, repairs are carried out free of charge when the customer brings back his vehicle. Campaign warranty costs must be recognized on an accrual basis on the date of the decision and should be computed taking into account the following:

- Number of units of the product produced during the period the problem occurred,
- Estimated proportion of the units produced affected by the problem in question,
- Estimated proportion of the units concerned that will be repaired,
- Estimated cost of parts and labor.

7.14 The auditor should ensure that the provision for campaign warranty is recognized once it has been approved/announced by the Company and is created on the basis of the estimated cost to be incurred by the Company in order to correct such defects.

7.15 Estimated refunds from the suppliers and the future gross profit on replacement parts and components should be treated as described under “contractual warranty” above.

C. Purchased Extended Warranty

7.16 In the recent years, automotive companies are launching purchased warranty schemes in the market which is over and above the normal warranty. In these schemes, usually some amount is charged to the customer. For instance, in a normal warranty scheme only manufacturing default is covered whereas in a purchased extended warranty scheme, all types of repairs, certain part replacements, defects etc. are also covered, usually for a period of 2 to 3 years.

7.17 The auditing issues herein would include the following:

- recognition of revenue for the amounts collected from the buyer.
- recognition of the warranty cost.
- recognition of the upfront loss in the contract.
- as this extended warranty is for more than a year, matching of cost with revenue over the period.

Illustration

Background

X Auto Limited, a manufacturer of car model – Alpha, has launched a purchased extended warranty scheme for a period of 3 years along with the sale of car. The sale price of Alpha is Rs. 500,000 and Rs. 10,000 is collected for this extended warranty scheme. X has determined that total extended warranty cost would be Rs. 16,000 over the period.

Solution

X should recognize the revenue of Rs. 500,000 on sale of vehicle. Rs. 10,000 collected on sale of extended warranty scheme should be recognized over the period i.e., 36 months. Therefore, revenue would be as follows: Year I – Rs. 3,333.33; year II – Rs. 3,333.33; Year III – Rs. 3,333.33.

The upfront loss of Rs. 6,000 should be recognized immediately on the sale of Alpha.

The policy for recognizing the cost should be reviewed by the Company on regular basis. It is prudent to recognize the cost in proportion to the revenue recognized.

Audit procedures

- The terms of the extended purchase warranty agreement should be checked by the auditor to ensure that the revenue and cost has been accounted correctly.
- Since the data may be voluminous, arithmetic accuracy

should be ensured by the auditors.

- The historical data should be checked on a test check basis to ensure the accuracy.

Provision for Retrospective Price Amendments

7.18 Due to price fluctuations in the market and as per the terms of arrangement with the vendors, automobile companies may sometimes have to pay its vendors for an increase in the prices of goods purchased from them.

7.19 Based on further negotiations with the vendors, the Company finalizes the price increase that needs to be given to the vendor. The increase in prices could be retrospective or sometimes prospective.

7.20 The Company needs to make a provision for all retrospective price amendments in the books of account. The Company should ensure the following:

1) Prepare a list of all vendors where a price increase provision needs to be made.
2) Whether goods received for which the price increase provision is to be made are in stock or consumed.
3) Debit inventory if the goods are in stock or debit consumption if the goods are already consumed and credit vendor with the amount of price increase.

7.21 The auditor should ensure the following:

1) Appropriate approvals are in place for the price amendments.
2) Provision is made for all the goods received as per the terms of contract/ agreement with the supplier.
3) Analyze all subsequent supplier claims to ensure completeness of the provision made.

Other Items

7.21 Other items that are included under liabilities and provisions are as follows:

- Deposits from customers/dealers.
- Advances from customers.
- Legal disputes, such as litigation and claims.
- Book overdrafts.
- Dividend payable.
- Unpaid salary balance.
- Employee recoveries.
- TDS deducted.
- Sundry creditors for materials, expenses and capital goods.
- Stale cheques not presented by payee for which the liability is restored.
- Service tax payable.
- Interest accrued but not due.
- Provision for gratuity and leave encashment.

These balances may be verified in a manner similar to that followed in other industries.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material misstatement

7.22 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering "what can go wrong" for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

7.23 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor's cumulative knowledge of the entity.

7.24 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

7.25 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity's controls, including control activities, relevant to that risk.

7.26 Hence, these audit procedures will vary according to the given situation.

Material Classes of Transac-tions, Account Balances and Disclosures	**Assertions**		**Illustrative Audit Procedures (these procedures will vary according to the given situation)**
Current liabilities and Provisions			
		A	**System update**
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	**Recording accuracy**
	Completeness	1	Obtain a schedule of current liabilities and Provisions. Test the total and reconciliation of the total to: • Trial balance. • General ledger. • Balance sheet.
		C	**Review of balances**
	Completeness, Valuation & Allocation, Rights & Obligations	1	Review and explain movements between current year, prior year and budgeted amounts for all significant amounts.
	Rights & Obligations	2	Review the information in prior year working papers and/or enquire concerning the nature of each significant account and the policies and procedures used to account for them.
	Valuation & Allocation,	3	Determine that the accounting policies and procedures for

	Rights & Obligations		identifying when liability should be recorded are applied consistently.
	Valuation & Allocation	4	Compare payments subsequent to year end with year-end other current liabilities.
	Valuation & Allocation, Rights & Obligations	5	Investigate for any journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements at the year end and test the appropriateness of such entries.
	Valuation & Allocation, Rights & Obligations	6	Obtain an understanding of the business rationale for significant transactions that are outside the normal course of business of the entity, or that otherwise appear to be unusual given the understanding of the entity and its environment and other information obtained during the audit engagement.
		D	**Test Unusual Items**
	Valuation & Allocation, Rights & Obligations, Existence	1	Review the other payables control account for the year and investigate the nature of large and unusual items (e.g. entries not arising from normal posting sources, debit entries that do not arise from payment sources) and trace to supporting documents. Review the control account for the first month subsequent to year-end and investigate for large and unusual items that do not follow expected trends.
	Valuation &	2	Review payable accounts with

	Allocation, Rights & Obligations		significant debit balances and check for any misstatements.
	Valuation & Allocation, Rights & Obligations, Existence	3	Review old outstanding balances and determine if these are periodically reviewed by the management and action taken to liquidate such balances.
		4	Evaluate results of the tests.
		E	**Test the Propriety of Accrued Expenses and Other Liabilities Accounting Policies and Procedures**
	Completeness, Valuation & Allocation, Rights & Obligations	1	Review the information in prior-year working papers and/or inquire concerning the policies and procedures used to account for significant accrued expenses (such procedures may include identifying who determines the need for the accrual, who accumulates reliable data on which to base accruals, who reviews and approves accruals, who compares recorded accruals with subsequent results).
	Valuation & Allocation	2	Inquire as to the reasons for significant changes in accrued expense since the prior year-end.
	Valuation & Allocation, Rights & Obligations	3	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on accrued expense balances and determine that the accounting policies and procedures for identifying when accrued expenses should be recorded

			are appropriate and applied consistently.
	Valuation & Allocation	4	In the course of performing audit procedures in this program, consider whether the audit evidence examined supports the understanding of the accrued expenses accounting policies and procedures and their propriety.
		5	Evaluate results of the tests.
		F	**Test Accrued Expenses and Other Liabilities**
	Valuation & Allocation, Rights & Obligations, Completeness	1	Obtain the payables trial balance and test the summarization and reconciliation of the total to the general ledger. Trace significant reconciling items, if any, to supporting documents.
	Valuation & Allocation, Rights & Obligations	2	For selected subsequent cash disbursements or unpaid invoices that indicate liabilities incurred but not recorded as accounts payable at the year-end, ascertain whether they were recorded in an appropriate accrued expense account.
	Valuation & Allocation, Rights & Obligations	3	Inquire of management and review information in prior-year working papers concerning the nature of recorded accrued expenses and identify the specific need for such accrual.
		4	Obtain a roll-forward schedule by provision type, and test the reconciliation to the general ledger:
	Valuation & Allocation,		• For the provision existing at the beginning of the

	Rights & Obligations		year, verify that the provision is still valid.
	Valuation & Allocation, Rights & Obligations		• Test the charges/additions to the provision.
	Valuation & Allocation, Rights & Obligations		• Test the reversals of the provisions made in the prior period.
	Valuation & Allocation, Rights & Obligations, Completeness		• Search for contingent liabilities, and consider the need to record additional provision.
	Valuation & Allocation, Rights & Obligations		• Consider the effects of subsequent events to provision and contingent liability.
	Valuation & Allocation,		• Evaluate the overall reasonableness of the ending provision balances.
	Valuation & Allocation, Rights & Obligations	5	For contingent liabilities identified, understand the nature and evaluate the reasonableness of the disclosures.
	Completeness	6	Inquire and consider other available evidence, if any, that unrecorded or under recorded liabilities exist. Consider the following sources of evidence, among others, as applicable:
			• Prior year balances of accrued expense accounts.
			• Prior and current year balances of related expense accounts.
			• Minutes of meetings of those charged with

			governance.
			• Discussions with internal legal counsel.
			• Responses to letters of inquiry to independent legal counsel.
			• Employee benefit plans (e.g. pension, medical, vacation, deferred compensation), and reports from actuaries, insurance companies etc.
			• Subsequent payroll records.
			• Periodic expenses (e.g. rent, rates, utilities).
			• Interest on loan.
			• Sales commissions
			• Significant contracts for services performed in the audit period.
			• Information about changes made or planned in the entity's business, including changes in operating strategy, and the industry in which the entity operates.
			• Regulatory or examination reports.
			• Subsequent significant disbursements.
	Rights & Obligations	7	For accrued expenses that have not changed significantly since the prior year-end, assess whether the circumstances requiring the accruals in the prior year still exist.
	Valuation &	8	For accruals that are based

	Allocation, Rights & Obligations		primarily on known data (i.e. that are not accounting estimates), examine documents supporting the amounts accrued (e.g. service contracts or invoices, subsequent payroll records, property tax statements etc) and cash disbursements in the period subsequent to the year-end.
		9	For accrued expenses that are accounting estimates (e.g. accrued vacation), perform the following procedures:
	Valuation & Allocation, Rights & Obligations, Existence		• Obtain written documentary evidence supporting the estimates.
	Valuation & Allocation, Rights & Obligations		• Evaluate the reasonableness of the methods and assumptions management used to make the estimates.
	Valuation & Allocation, Rights & Obligations		• If management's methods and assumptions were reasonable, test the data and assumptions underlying the estimates and recompute the estimates.
	Completeness		• Determine that the data used to make independent estimates is independent and reliable and if using information produced by the client, obtain audit evidence about the accuracy and completeness of the data.

	Valuation & Allocation		• In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	Valuation & Allocation, Rights & Obligations, Completeness		• If management's methods and assumptions were not reasonable, develop an independent range of reasonable estimates and determine whether management's estimates fall within that range (Note: The factors that might be considered will vary according to the nature of the liabilities).
			* Identify those factors and assumptions that are relevant to developing the estimate.
			* Accumulate and test relevant supporting data.
	Valuation & Allocation, Rights & Obligations, Completeness		• If the recorded estimate falls outside of the independent range, post the difference between the management's estimate and the nearest point in the auditor's expected range as a likely misstatement on 'Evaluation of Misstatements'.
	Valuation & Allocation, Rights & Obligations,	10	For selected accruals with significant balances in the prior year that no longer exist or that have significantly lower

	Existence		balances in the current year:
			• Assess whether the circumstances requiring the accruals in the prior year no longer exist or whether they warrant reductions in the amounts accrued.
			• If the accounts consist of only one or very few transactions (e.g. a prior year accrual for a legal liability), trace the disposition of the liability to supporting documents.
		11	Evaluate results of the tests.
		G	**Test deductions from employees payroll**
	Valuation & Allocation, Rights & Obligations, Completeness	1	Perform substantive analytical procedures to test the amounts to be deducted from employees (for PF and ESIC contributions) and trace the contribution by the entity during the year. Consider developing an expectation of the contribution payable during the year based on:
			• Prior period balances.
			• Monthly amounts of salaries during the year compared to such monthly amounts in the prior year.
	Completeness	2	Determine that the data used to make independent estimates is independent and reliable and if information produced by the entity is used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation	3	In assessing the reliability of the data gathered, consider the

			source of the data and the conditions under which it was gathered.
	-	4	Determine the threshold – the amount that represents the maximum difference between the expectation and the recorded contributions that is acceptable without further investigation.
	-	5	Compare the expectation to the recorded balance and identify any differences. For any difference that is more that the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		6	Consider investigating the following:
	Valuation & Allocation, Rights & Obligations		• Any unusual pattern in the differences.
	Valuation & Allocation, Rights & Obligations, Completeness		• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result

			of fraud risks.
	Valuation & Allocation, Rights & Obligations	7	Corroborate explanations by examining supporting evidence and/or by enquiries directed to persons outside the entity or to independent persons inside the entity.
	Valuation & Allocation, Rights & Obligations, Completeness	8	For selected payments for wages and salaries, check amounts deducted from employees' pay and corresponding contribution by the entity with reference to the rates to be applied, eligible employees, components of pay etc.
	Valuation & Allocation, Rights & Obligations	9	Investigate reasons for any differences and determine whether any errors have been corrected subsequently by adjustment of employees' deductions.
	Valuation & Allocation, Rights & Obligations	10	Review deductions for the year and identify any delays made in depositing deductions in time.
		11	Evaluate results of the tests.
		H	**Test liability for sales tax etc.**
	Valuation & Allocation, Completeness	1	Review sales tax returns for the last quarter and check adequacy of accrual at the year-end. Trace payments to subsequent disbursement records.
	Valuation & Allocation, Rights & Obligations, Completeness, Existence	2	Review the present status of assessments in progress and identify any demands received during the year from authorities and inquire on the status of such demands:
			• Where the demands are

			disputed by the entity and an appeal has been filed, or in the process of being filed, consider disclosure of such demands as a contingent liability.
			• Where the entity has provided against the demand, consider the adequacy of such provision.
	Valuation & Allocation, Rights & Obligations, Existence	3	Determine and note any undisputed amounts of sales tax, income tax, service tax, customs duty, excise duty, wealth tax and cess which was outstanding for more than six months as at the year-end.
		4	Evaluate results of the tests.
		I	**Test acceptances**
	Valuation & Allocation, Rights & Obligations, Completeness, Existence	1	Where bills of exchange are used as a mode of payment to vendors, determine that the accounting policies and procedures for recording such transactions are appropriate. [At the year-end, outstanding bills of exchange accepted but not matured are accounted for as one of the period end entries].
	Valuation & Allocation, Rights & Obligations, Completeness	2	Obtain the schedule of bills accepted but not matured at the year-end and test the summarization and the reconciliation of the total to the general ledger. Trace significant reconciling items, if any, to the bills payable register and supporting documents.

	Valuation & Allocation, Completeness	3	Make a selection of bills accepted but not matured from the bills payable register and trace to supporting documents and subsequent payments.
	Existence, Completeness	4	For bills of significant amounts, consider obtaining confirmation form parties.
	Valuation & Allocation	5	Test calculation of accrued interest, if any on bills payable.
		6	Evaluate results of the tests.
		J	**Test unclaimed dividends**
	Completeness	1	Obtain details of unclaimed dividend at the year-end and test the summarization. Trace the total to the general ledger.
	Valuation & Allocation, Rights & Obligations	2	Determine that the provisions of section 205A as regards the transfer of unpaid and/or unclaimed dividends in a separate bank account and/or to the Central government have been complied with.
		3	Evaluate results of the tests.
		K	**Test deferred income**
	Valuation & Allocation, Rights & Obligations, Completeness	1	For significant sources of income, consider if any income should be deferred to future periods. Consider that the deferral is appropriate and consistent with the prior year.
	Valuation & Allocation, Rights & Obligations	2	Test calculation of deferred income and trace to supporting documents.
		3	Evaluate results of the tests.
		L	**Test Balances Denominated in Foreign Currencies**
	Completeness	1	Inquire and consider other available evidence, if any, to

			identify foreign suppliers with which purchase transactions were in foreign currency.
	Valuation & Allocation	2	Agree the closing rate(s) used to published records and test the translation calculation for items which are monetary as per Accounting Standard 11.
	Valuation & Allocation	3	Trace currency translation adjustments to the general ledger.
		M	**Test movements on Provisions**
	Valuation & Allocation	1	If any costs have been charged against provisions, determine that such charge is appropriate based on the circumstances.
	Valuation & Allocation, Rights & Obligations	2	For amounts released to the profit & loss account, assess whether the circumstances requiring the provisions in the prior year no longer exist or whether they warrant reductions in the amounts accrued.
	Valuation & Allocation	3	Inquire into any other movements in provisions and check that they are appropriate based on circumstances and is adequately supported.
	Completeness	4	Determine that the treatment of over or under provisions arising from provisions since the prior year-end is appropriate.
		N	**Test provision for gratuity**
	Valuation & Allocation, Rights & Obligations, Completeness	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on gratuity payable to employees of the entity.

	Valuation & Allocation, Rights & Obligations, Completeness, Existence	2	Inquire and determine the procedures adopted by the entity for payment of gratuity and test the provision for the following:
			• Payments are made from the funds of the entity. Test the year-end provision recorded in the general ledger on the basis of an actuarial valuation.
			• Payments are made by a trust set up by the entity. Test the year-end contribution to the trust on the basis of an actuarial valuation.
			• Payments are made through a scheme administered by the insurance service provider. Test the year-end contribution to the insurance service provider as intimated by the insurance service provider.
	Rights & Obligations, Existence	3	Obtain a copy of the trust deed and rules, current year and prior year valuation report of the actuary, any other statements issued by the actuary subsequent to the last valuation report.
	Valuation & Allocation, Rights & Obligations, Completeness, Existence	4	If liability for payment of gratuity is determined by an actuarial valuation, review the valuation report of the actuary and ensure through discussions with the actuary:

			• Reasonableness of the data provided by the entity for the purpose of an actuarial valuation and whether such data is comparable to industry norms.
			• Effect on the valuation of any legislative changes, if any, since the date of the year-end valuation.
			• Effect on the valuation of any changes in the scheme or rules, if any, since the date of the year-end valuation.
			• Recommendation of the actuary for dealing with any material surplus or deficiency.
			• Cost of any past service benefit awards made during an inter-valuation period for which no allowance was made in the funding plan.
			• Any additional reports by the actuary or any other matters concerning the valuation.
			• Reason for any qualification/reservation by the actuary in his valuation report.
	Valuation & Allocation	5	If the liability for payment of gratuity is not determined by an actuarial valuation (number of employees being few), test the basis adopted for recording an estimate and ensure that such estimate is, at the minimum, in

			line with the Payment of Gratuity Act.
		6	Evaluate results of the tests.
		O	**Test Other Provisions**
	Valuation & Allocation, Rights & Obligations, Completeness	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements for provisions.
	Valuation & Allocation, Rights & Obligations, Completeness	2	Inquire of management and review information in prior-year working papers concerning the nature of recorded provisions and identify the specific need for such provisions.
		3	Obtain a roll-forward schedule of provisions showing beginning and ending balances, current-year adjustments and current-year provisions and perform the following:
	Valuation & Allocation, Rights & Obligations, Completeness		• Test the mathematical accuracy of the schedule and agree the beginning balances to prior year working papers and the ending balances and current-year provisions to the general ledger. Trace significant reconciling items, if any, to supporting documents.
	Valuation & Allocation, Rights & Obligations		• For the provision existing at the beginning of the year, verify that the provision is still valid.
	Valuation & Allocation		• Test the charges/additions to the provision.
	Valuation & Allocation		• Test the reversals of the provisions made in the

			prior period.
	Valuation & Allocation, Rights & Obligations, Completeness		• Search for contingent liabilities, and consider the need to record additional provision.
	Valuation & Allocation, Rights & Obligations		• Consider the effects of subsequent events to provision and contingent liability.
	Valuation & Allocation		• Evaluate the overall reasonableness of the ending provision balances.
	Completeness	4	Inquire and consider other available evidence, if any, that unrecorded or under recorded provisions exist. Consider the following sources of evidence, among others, as applicable:
			• Prior year balances of provisions.
			• Minutes of meetings of those charged with governance.
			• Warranties granted.
			• Maintenance obligations under contracts.
			• Cost of completion of contracts which have been included in the turnover.
			• Gratuity benefits not covered by gratuity schemes.
			• Other claims against the entity.
	Valuation & Allocation, Rights & Obligations	5	For provisions that have not changed significantly since the prior year-end, assess whether the circumstances requiring the provisions in the prior year still exist.

	Valuation & Allocation, Rights & Obligations, Existence	6	For provisions that are based primarily on known data (i.e. that are not accounting estimates), examine documents supporting the provisions.
		7	For provisions that are accounting estimates, perform the following procedures:
	Valuation & Allocation, Rights & Obligations		• Obtain written documentary evidence supporting the estimates.
	Valuation & Allocation		• Evaluate the reasonableness of the methods and assumptions management used to make the estimates.
	Valuation & Allocation		• If management's methods and assumptions were reasonable, test the data and assumptions underlying the estimates and recompute the estimates.
	Completeness		• Determine that the data used to make independent estimates is independent and reliable and if information produced by the entity is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation		• In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	Valuation &		• If management's methods

	Allocation, Rights & Obligations, Completeness		and assumptions were not reasonable, develop an independent range of reasonable estimates and determine whether management's estimates fall within that range (Note: The factors that might be considered will vary according to the nature of the liabilities).
			* Identify those factors and assumptions that are relevant to developing the estimate.
			* Accumulate and test relevant supporting data.
			• If the recorded estimate falls outside of the independent range, post the difference between the management's estimate and the nearest point in the auditor's expected range as a likely misstatement.
	Valuation & Allocation, Rights & Obligations	8	For selected provisions with significant balances in the prior year that no longer exist or that have significantly lower balances in the current year:
			• Assess whether the circumstances requiring the provisions in the prior year no longer exist or whether they warrant reductions in the amounts accrued.
		9	Evaluate results of the tests.
		P	**Test Presentation of**

			Provisions
	Classification & Understand-ability, Accuracy & Valuation, Completeness, Occurrence & rights and obligations	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on provisions.
	Classification & Understand-ability, Accuracy & Valuation, Occurrence & rights and obligations	2	Determine that amounts presented as provisions are properly recorded, classified and/or disclosed as required by Schedule VI to the Companies Act: • Provision for taxation. • Provision for contingencies. • Provision for provident fund scheme. • Provision for insurance, pension and other staff benefit schemes. • Provision for warranty. • Provision for liquidated damages. • Provision for anticipated loss on contracts. • Provision for interim, proposed final dividend and dividend tax. • Other provisions.
		Q	**Test Presentation of Accrued Expenses**
	Classification & Understand-ability, Accuracy & Valuation, Completeness,	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on other current liabilities.

	Occurrence & rights and obligations		
	Classification & Understand-ability, Accuracy & Valuation, Occurrence & rights and obligations	2	Determine that amounts presented as other current liabilities are properly recorded, classified and/or disclosed as required by Schedule VI of the Companies Act: • Acceptances. • Advance payments. • Dues to subsidiary companies. • Unclaimed dividends. • Interest accrued but not due on loans. • Other liabilities, if any. • Balance in current account with directors and/or managers.
	Accuracy & Valuation	3	Check that security deposits received from employees are kept in a separate bank account
	Classification & Understand-ability, Accuracy & Valuation	4	If applicable, determine that the balances listed below are properly classified. Extract the following information:
			• Debit balances in accrued expenses.
	Classification & Understand-ability, Accuracy & Valuation, Completeness, Occurrence & rights and obligations	5	If applicable, determine that the items listed below are properly recorded, classified, and/or disclosed. Extract the following information:

			• Accrued expenses owed to related parties.
			• Lease obligations.
	Completeness	6	Obtain from the management the information identifying all known related parties, account balances and transactions, and test the information for completeness.
	Classification & Understand-ability, Accuracy & Valuation, Occurrence & rights and obligations	7	Examine the identified related party balances or transactions, and obtain sufficient appropriate audit evidence as to whether these account balances or transactions have been properly recorded and disclosed.
		R	**Conclusion**
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.
	-	2	Consider including the following when documenting the conclusion: • A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. • The relevant potential errors and control objectives for each account balance or disclosure being tested. • The substantive procedures

			performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors. • The results of substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure. • The tests of controls performed or a cross reference to where the tests of controls performed are documented. • The results of tests of controls, including deficiencies identified, and how such results support the conclusion as to whether control reliance for the potential errors for each account balance or disclosure has been obtained.

Chapter 8
Other Income

8.1 While auditing other income, the auditor is primarily concerned with obtaining a reasonable assurance that the income recorded is based on the transactions that took place during the relevant period and pertains to the entity, that there is no unrecorded income, and that the income is recorded in the proper amounts and is allocated to the proper period.

Brand Fees

8.2 Generally, in the automobile industry oil, paint, tyre etc. suppliers enter into an agreement with the Company in order to promote their brand. The automobile Company charges fees from these companies for using their brand name on the product. Such income is recognized as “Other Income” in the statement of profit and loss.

8.3 The auditor should verify the rates with the agreement and ensure that the accounting is in accordance with the agreement.

Scrap Sales

8.4 Besides steel, in an automobile industry, other metals such as aluminium and copper can also be scrapped and have a high salvage value. It is always cheaper, more efficient and environment friendly to recover metals from scrap than by mining and processing raw materials. Unbroken windows and windshields are removed intact and are resold to the car owners who need replacements. Broken glasses can be recycled. The leftover is put in a crusher that uses a mobile bailing press or a flattener to crush the car and then, is run through a hammer mill that smashes the remains into fist-sized pieces. These can be sold as scrap. Besides auto salvage yards and scrap recyclers, there is an industry of auto scavengers and auctioneers who compete to be the middlemen in obtaining cash for scrap cars by selling the cars

to the highest bidder. Besides this, removable parts like headlights, taillights, blinkers, mirrors, parts of the exhaust system, seats etc. which can be resold as used repair parts, major parts such as transmissions and engines can also be sold to auto parts companies who can rebuild these parts and sell them in the market.

8.5 The auditor should ensure that Company has an appropriate control system for approving generation of scrap and wastages/rejections. These rejections and wastages should be analyzed by the appropriate authority levels in the Company on a timely basis. The auditor should also analyze input out ratios and compare the scrap generation with past trend and document reason for major variances, if any.

8.6 The auditor should check the controls the Company has with respect to accounting and safe storage of scrap. The auditor should also verify the accounting treatment for the scrap sales. Generally, all the auctions are on advance receipts basis. The bidding documents, procedure of auction and settlement for the same should be verified along with the deduction of proper TCS on the transaction.

Accounting for Export Benefits

8.7 One significant item of other income for automobile companies is the various export benefits that they get from the government agencies. These export benefits could be in the form of duty drawback, duty credits etc. The auditor should review the accounting policy followed by the Company in accounting for such export benefits and ensure that the same is reasonable. Normally export benefits are accounted for on accrual basis considering the eligibility of the Company and when there is no uncertainty in receiving the same. The auditor should verify the licenses and other approvals received from the government entitling the Company to these export benefits. The auditor should verify whether the export benefits have been accounted for in respect of all export sales during the period under audit unless the same does not qualify for recognition under the principles laid down in A 9- Revenue Recognition.

8.8 The auditor should also ensure that appropriate disclosures are made for the accounting policy followed by the Company in respect of accounting for export benefits.

Provisions Written Back

8.9 Any excess provision of the previous year, which no longer may be required, is credited to the statement of profit and loss.

8.10 The auditor should enquire about the reasons for these provisions written back and why these provisions were created originally. The correspondences with the supplier, if any, should be checked. It should be ensured that the provisions written back are old and management is able to prove that these are no longer payable.

Interest on Income Tax Refunds

8.11 Where an assessment order is received during the year, the auditor should examine the assessment order and if any interest is received along with the amount of refund, it should be considered as income. In case, where the assessment results in a fresh demand, the auditor should consider the need for additional provisioning. Where an assessment order is received during the course of audit, the auditor should examine and consider its impact, if any, on the accounts and the financial statements.

8.12 It is not prudent to recognize interest on a possible refund which has not been determined in any order received from the tax authorities.

Profit on Sale of Investments

8.13 Profit on the sale of investments (in the form of quoted investments, units of mutual funds, debentures etc.) is included under this head. The auditor should verify this in a manner similar to that followed in any other industry.

Profit on Sale of Fixed Assets

8.14 This includes profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, plant and machinery etc.

8.15 The auditor should verify the supporting documents for the sale such as the management approval, the policy of the Company, invoices, quotations invited to verify the transaction etc.

8.16 The auditor should verify the entries made in the fixed asset register in order to check the accuracy of the transactions.

Interest Income

8.17 Automobile industry is a capital-intensive industry. Most companies carry large amounts of debts in their balance sheets and rarely, have surplus funds. However, the entity may have invested temporary surplus funds in fixed deposits. Interest on such deposits may be verified by the auditor in a manner similar to that followed in any other industry. The auditor should verify the computation of the interest, its accounting and the TDS details related to it. TDS details can be verified from the Form 16A.

8.18 Interest can also be received on inter-Company deposits placed with the group companies or other corporate bodies. The auditor should ensure that the interest is recognized accurately in the books of accounts by verifying the principal amount, the rate of interest and the period of loan.

8.19 Interest on delayed payments by customers should be verified with reference to the terms of sales.

Income from Investments

8.20 This includes the income derived from the investment portfolio by way of interest and dividend including dividends received from subsidiaries and joint ventures in India/abroad.

8.21 The auditor should ensure that income is recognized accurately in the books of accounts by verifying the principal amount, the rate of interest and the period of investment.

Dividends

8.22 Dividends received should be checked with reference to counterfoils of dividend warrants. As per AS 9, Revenue Recognition, dividends should be recognized when the right to

receive the payment is established.

8.23 The auditor should ensure that dividend income is recognized accurately in the books of accounts by verifying the principal amount and the dividend rate declared by the investee Company.

Foreign Exchange Fluctuations

8.24 Foreign exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates. Exchange rate is the ratio for exchange of two currencies. Foreign currency is a currency other than the reporting currency of an enterprise.

8.25 Foreign currency transactions are recorded at the rates of exchange prevailing on the date of the transactions according to AS-11.

8.26 There are two types of gains related to foreign exchange fluctuation:

1. Realized Gain: The gain which is actually realized during the year and not arising due to restatement of monetary items at the closing rate.

2. Unrealized Gain: Monetary foreign currency assets and liabilities are translated into rupees at the rate of exchange prevailing on the balance sheet date.

8.27 The differences arising on the translation of monetary assets and liabilities (unrealized) and realized gains and losses on foreign currency transactions are recognized in the profit and loss account.

8.28 The auditor should verify the accounting treatment of the exchange rate differences and should ensure that it is in accordance with AS-11.

Miscellaneous Receipts

8.29 Recovery of liquidated damages under a contract, late payment charges from the customers, interest on staff loans and advances, insurance claims, stale check credits etc. are credited to this account.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material misstatement -

8.30 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering "what can go wrong" for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

8.31 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor's cumulative knowledge of the entity.

8.32 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

8.33 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity's controls, including control activities, relevant to that risk.

8.34 Hence, these audit procedures will vary according to the given situation.

Other Income

Material Classes of Transactions, Account Balances and Disclosures	Assertions		Audit Procedures
Other Income		**A**	**System update**
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	**Recording accuracy**
	Completeness	1	Obtain/prepare a schedule of various heads of accounts in other income. Test the total and reconciliation of the total to: • Trial balance. • General ledger. • Profit & Loss Account.
		C	**Review of balances**
	Occurrence, Accuracy, Completeness	1	Review and explain movements between current year, prior year and budgeted amounts for all significant amounts.
	Classification	2	Review the information in prior year working papers and/or inquire the nature of each significant account and the policies and procedures used to account for them.
	Accuracy	3	Determine that the accounting policies and procedures for identifying when other income should be

			recorded are applied consistently.
	Accuracy, Occurrence	4	Investigate for any journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements at the year end and test the appropriateness of such entries.
	Accuracy, Classification, Occurrence	5	Review accounts for the year and investigate the nature of large and unusual items (e.g. credit entries that do not arise from receipt) and trace to supporting documents.
	Accuracy, Classification, Occurrence	6	Review income accounts with significant debit balances and check for any misstatements.
		7	Investigate all significant variations.
		D	**Test Other Income**
			Certain account balances in other income (e.g. profit on sale of fixed assets would be tested in the Model Audit Programs for fixed assets. It is important to avoid any repetition.
	Occurrence, Accuracy, Completeness	1	Perform substantive analytical procedures to test other income by developing an expectation of other income from independent data.
	Occurrence, Accuracy, Completeness	2	Consider disaggregating the data used to build the expectations and the recorded operating expenses at a level of detail sufficient to

			enable us to obtain the desired level of assurance based on a comparison of the amounts. Consider the following means of disaggregation:
			• By period.
			• By account, product line, or both.
			• By division or location.
	Accuracy	3	Determine that the data used to make independent estimates is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Accuracy	4	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	-	5	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded other income that is acceptable without further investigation.
	-	6	Compare the expectations to the recorded amounts and identify any differences. For any difference that is more that the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting

			documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		7	Also consider investigating the following:
	Occurrence, Accuracy		• Any unusual pattern in the differences.
	Occurrence, Accuracy		• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud risks.
		8	Make a selection of recorded other income from independent source documents and perform the following:
	Completeness		• Test the numerical sequence of the source records, if numerically controlled, or otherwise test the completeness of the records.
	Occurrence, Accuracy		• Trace the selection to an invoice or other supporting documents.
	Accuracy		• Verify additions and extensions on the invoice.
	Accuracy		• Test calculation of other income.

	Cut Off		• Determine that the income was recorded in the correct period.
	Completeness		• Trace the amount to the general ledger.
		9	Evaluate results of the tests.
		E	**Test operating leases where entity is a lessor**
		1	Obtain schedules of operating leases where entity is a lessor showing beginning and ending balances and lease additions and terminations during the current period and perform the following:
	Completeness		• Test summarization of the schedule.
	Completeness		• Trace ending balances to the general ledger.
	Accuracy, Occurrence		• Trace details to agreements.
	Accuracy		• Determine the propriety of capitalization for items included.
	Accuracy		• Determine the propriety of the depreciation methods used.
	Accuracy, Occurrence		• Trace the lease income to the general ledger and cash receipt records.
	Completeness	2	Make inquiries of management, and consider whether evidence obtained from other audit procedures indicates the existence of additional leases.
		3	Make a selection of items from the beginning balances and current period additions

			column of the schedule.
	Accuracy, Occurrence		• Trace the minimum lease payments and the period of the lease to supporting documents (e.g. lease agreements). • Recompute current period depreciation expense.
	Accuracy, Occurrence	4	Prepare, or have the entity prepare, confirmation requests for all leases at Step E.1. On the confirmation, consider including outstanding balance and rental income received.
			• Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the entity) and request that all replies be sent directly to the auditor's office.
			• Send second request for non-replies. Request the entity to follow up, if necessary.
			• Compare replies to requests. Prepare, or have the entity prepare, reconciliation of exceptions. Trace reconciling items to supporting documents

			(e.g. lease agreements, bank statements) and determine that the lease rental income has been properly recorded.
			• Trace non-replies to subsequent cash receipts from lessees.
			• Inquire into any significant disputed balances. Investigate as necessary.
		5	Evaluate results of the tests.
		F	**Test Foreign Currency Transactions**
	Completeness	1	Inquire and consider other available evidence, if any, to identify transactions in foreign currency.
	Accuracy	2	Agree the closing rate(s) used to published records and test the translation calculation for items which are monetary in nature as per Accounting Standard 11.
	Accuracy, Classification	3	Trace currency translation adjustments to the general ledger.
		G	**Test scrap sales**
	Accuracy, Occurrence, Completeness	1	Perform substantive analytical procedures to test scrap sales. Consider developing an expectation of scrap sales during the year:
			• Historical and current year trends in scrap sales.
			• Historical and current year trends in costs of scrap sales and gross margins.

			• Beginning and ending balances in scrap inventory accounts.
	Accuracy	2	Determine that the data used to make independent estimate is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Accuracy	3	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	-	4	Determine the threshold – the amount that represents the maximum needed to identify a significant difference between the expectation and the recorded scrap sales balance that is acceptable without further investigation.
	-	5	Compare the expectation to the recorded balance and identify any differences. For any difference that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
	Accuracy,	6	We also consider

	Completeness, Classification		investigating the following:
			• Any unusual pattern in the differences.
			• Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud risks.
		7	Perform tests of details of scrap sales:
	Accuracy, Occurrence		• Trace the item to a sales invoice.
	Accuracy		• Verify additions and extensions on the invoice.
	Accuracy		• Ensure that VAT and excise duty has also been included in the sales invoice. Trace excise duty on the invoice with the excise records.
	Accuracy, Occurrence		• Agree the sales to advances received from the dealers. Trace the advance received to cash receipt records.
	Classification	8	Investigate the reasons for generation of scrap (i.e. normal or abnormal). Verify that scrap generation documents have been

			properly authorized.
	Occurrence	9	Consider confirmation of scrap sales.
		10	Evaluate results of the tests.
		H	**Test Presentation of Other Income**
	Classification, Understand-ability, Valuation, Accuracy	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on other income.
	Classification & Understand-ability, Valuation & Allocation **Classification & Understand-ability** **Classification & Understand-ability, Valuation & Allocation** **Classification & Understand-ability, Valuation & Allocation** **Classification & Understand-ability, Valuation & Allocation** **Classification**	2	Determine that amounts presented as other income are properly recorded, classified and/or disclosed as required by Schedule VI of the Companies Act: • Interest and dividend from investments (showing separately interest/dividend from subsidiary companies, income from long-term and current investments as well as from trade investments and other investments. • Gross income, showing separately taxes deducted at source. • Profit on disposal of long-term and current investments. • Profit on sale of fixed assets. • Miscellaneous income. • Earnings in foreign exchange classified under:

	& Understand-ability, Valuation & Allocation, Completeness, Occurrence & rights and obligations		• Royalty, know-how, professional and consultancy fees. • Interest and dividend. • Other income, indicating the nature thereof. • Income from related parties.
		I	**Conclusion**
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.
	-	2	Consider including the following when documenting the conclusion: • A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. • The relevant potential errors and control objectives for each account balance or disclosure being tested. • The substantive procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors. • The results of the

			substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure. • The tests of controls performed or a cross reference to where the tests of controls performed are documented. • The results of the tests of controls, including deficiencies identified, and how such results support the conclusion as to whether control reliance for the potential errors for each account balance or disclosure has been obtained.

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