ICAI Guidance Note on “Audit of Investments”

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Background:

Beside Cash and Cash Equivalents, Investments is the next highly liquid asset in the balance sheet of any entity. An entity will make investment just to park its surplus funds for a temporary period or will invest for a long term for earning income by way of dividends, interests, and rentals. Thus, based on the intention at the time of making the investment, it will be classified as “current investments” and “long term investments”. Considering the liquidity, investments are prone to misappropriation. Hence the management needs to take adequate care to safeguard the same. Further, the auditor needs to perform adequate procedures to confirm its existence and to ensure that the financial statements are true and fair. In this connection, the Institute of Chartered Accountant of India, has issued a Guidance Note on “Audit of Investments” (hereinafter “Guidance Note”) way back in 1994. With the change in technology and types of investments, this Guidance Note still holds good from the auditing point of view.

Synopsis:

A current investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date of investment. A long-term investment is an investment other than current investment. As regards Investments of an entity, the auditor is particularly concerned about its existence, completeness, valuation etc. He also needs to ensure whether there exists adequate internal control for the same. It is pertinent to note that the term “Investments” covers only such securities that are beneficially owned by the entity and not those held by it on behalf of others.

Internal Controls:

The Guidance Note mandate the auditor to study and evaluate the system of internal control relating to investments to determine the nature, timing and extent of his audit procedures particularly the following:

- Control over acquisition, accretion and disposal of investments: There should be proper authority for sanction, acquisition and disposal of investments and the same should be made in accordance with the legal requirements
- Safeguarding of investments: The investments should be in the name of the entity and there should be proper system for safe custody of all scripts or other documents of title to the investments belonging to the entity
- Controls relating to title to investments: It should be ensured that the title is passed on to the entity immediately on acquisition
- Information controls: These controls should ensure that reliable information is available for recording acquisitions, accretions and disposals, and for ascertaining the market values, etc.

Verification:

The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. In this connection he needs to perform the following procedures:

- Verification of transactions – It needs to be ascertained that the investments made are within the authority of the entity and complies with the legal requirements governing the entity and not ultra-vires of the entity. Adequate support of the investments, by due authority and documentation is also to be ascertained.
- Physical verification – The auditor should carry out a physical verification of investments. Where a substantial number of investments are kept by the entity in its custody, the auditor should carry out a surprise inspection of the investment on hand, at least once a year in addition to his year-end examination. If the investments are held by any other person on behalf of the entity, the auditor should examine the certificates received from them. Such certificates should preferably be received directly by the auditor. In cases where Immovable Properties are held as investments, the auditor should verify them in the same manner as in the case of immovable properties held as Property, Plant and Equipment.
- Examination of valuation and disclosure – To ensure whether the investment has been valued and disclosed in the financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements. The Guidance Note also discusses the disclosure requirements of some of the Acts in Appendix III.
- Analytical review procedures – As part of his audit procedure the auditor may relate the income received from investments with corresponding figures of investments and compare this ratio with the similar ratio for the previous years.

The nature, timing and extent of audit procedures to be performed is however, a professional judgment of an auditor. The investments can be in various forms, viz., Government Securities, Shares, Debentures, Mutual Funds, Immovable Properties etc., The Guidance Note prescribes the audit steps that need to be followed with special reference to investments in the form of shares, debentures and other securities.

Management Representation Letter:

The Auditor should obtain from the management of the entity a written representation (format prescribed vice Annexure IV) regarding classification and valuation of investments for Balance Sheet purposes. Though this serves as a formal acknowledgement of the management's responsibilities about investments, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial statement.

Documentation:

The auditor should maintain adequate working papers regarding audit of investments including the management representation letter as part of his audit file.

Conclusion:

Considering the liquidity, the auditor needs to be extra cautious while verifying the investments. He needs to get updated with the changes in the law, the process and types of investments in the current period of rapid changes in the economy and the way in which business operates. With the rapid changes in the technology, automation of processes and the new types of investment opportunities that are emerging, there is a paradigm shift in the audit process that needs to be planned and performed by the auditors. Considering all these, it is time for the ICAI to update and revise the Guidance Note at the earliest.

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