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Course:B.Com(PA) **Batch:2024-27** **Semester:IV**

SUBJECT: PRINCIPLES OF AUDITING

Unit:1		**20--hours**
Auditing– Origin – Definition – Objectives – Types – Advantages and Limitations – Qualities of an Auditor– Audit Programmes		
Unit:2		**18--hours**
Internal Control–Internal Check and Internal Audit–Audit Note Book–Working Papers.Vouching –Voucher– Vouching of Cash Book – Vouching of Trading Transactions–Vouching of Impersonal Ledger.		
Unit:3		**17--hours**
Verification and Valuation of Assets and Liabilities–Auditor's position regarding the valuation and verifications of Assets and Liabilities –Depreciation–Reserves and Provisions–Secret Reserves.		
Unit:4		**15--hours**
Audit of Joint Stock Companies – Qualification – Dis-qualifications – Various modes of Appointment of Company Auditor–Rights and Duties– Liabilities of a Company Auditor–Share Capital and Share Transfer Audit –Audit Report–Contents and Types.		
Unit:5		**18--hours**
Investigation– Objectives of Investigation– Audit of Computerised Accounts–Electronic Auditing–Investigation under the provisions of Companies Act.		
Unit:6	**Contemporary Issues**	**2hours**
Expert lectures, online seminars-webinars		
	Total Lecture hours	**90--hours**

INTRODUCTION

1
CHAPTER

Introduction - Meaning and Definition of Auditing - Difference between Book-keeping, Accountancy and Auditing - Auditing and Investigation - Scope of Auditing - Objects of Auditing - Auditor's Duty in relation to the Detection and Prevention of Errors and Frauds - Materiality in Auditing - Efficiency Audit - Propriety Audit - Techniques of Auditing - Qualities and Qualifications of an Auditor - Standards of Auditing - Basic Principles Governing an Audit - Annexure - I: Auditing and Assurance Standards (AASs) - Annexure - II: Accounting Standards (AASs).

INTRODUCTION

The practice of auditing, in a primitive form, can be traced back to ancient times, but auditing, as it exists today was established only in the latter part of the nineteenth century. Originally, auditing was confined solely to ascertain whether receipts and payments of an organisation have been recorded and accounted for. Hence, it was confined mainly to cash transactions. Now the scope of audit has been extended to verify the financial statements, and find out the financial status of the business. The method of audit has changed as per the accounting systems and needs of the different types of business. Hence we shall now proceed to discuss the meaning, definition, scope, objects, techniques and standards of auditing as well as other basic aspects to understand the concept of auditing in today's context clearly.

MEANING AND DEFINITION OF AUDITING

The term "**Audit**" is derived from the Latin word "**Audire**", which means, "**To hear**". In early days, the object of audit was to verify the receipts and payments. Separate persons were appointed to check the accounts. Their duty was to hear from the book-keepers matters relating to the transactions of the business. They check the transactions of the business with a view to find out arithmetical accuracy of the accounts, the correctness and truthfulness of the transactions recorded in the books of accounts, and of their results thereon. Now it's objects and scope have been extended to a greater extent. We shall now discuss the various definitions formulated for the term "**Auditing**".

Definition of Lawrence R. Dicksee

In the words of **Lawrence R. Dicksee**, "*Audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they relate. In some instances it may be necessary to ascertain whether the transactions themselves are supported by the authority*".

The above definition reflects clearly the auditing practices. However, it does not clarify its objects.

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Definition of Spicer and Pegler

Spicer and Pegler have defined the term auditing as an "*Examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy that the balance sheet is properly drawn up, so as to give a true and fair view of the state of the affairs of the business and whether profit and loss account gives a true and fair view of the profit or loss for the financial period according to the best of his information and the explanations given to him and as shown by the books, and if not, in what respects he is not satisfied*".

This definition is an exhaustive one and it explains the objectives of auditing in a clearer way.

Definition of F.M.R. De Paula

According to **F.M.R. De Paula,** "*Audit denotes something much wider, namely the examination of balance sheet and profit and loss account prepared by others. As a result of his examination of the books of accounts, vouchers, etc., and of his enquiries, the auditor must satisfy himself that such balance sheet and profit and loss account are properly drawn up so as to exhibit a true and fair view of the state of affairs and of the earnings of a particular concern*".

This definition resembles the definition of **Spicer** and **Pegler** and covers majority of the aspects covered by the latter.

Definition of Taylor and Perry

In the words of **Taylor** and **Perry,** "*An audit is an investigation by an auditor into the evidence from which the final revenue accounts and balance sheet or other statements of an organisation have been prepared, in order to ascertain that they present a true and fair view of the summarised transactions for the period under review and of the financial statement of the organisation at the end date, so enabling the auditor to report thereon*".

This definition also seems to be more exhaustive and clear.

To sum up, "*Auditing may be defined as an intelligent and a critical examination of the books of accounts of a business, which is done by an independent person or body of persons qualified for it, with the help of vouchers, documents, information and explanations received from the authorities, so that the auditor may satisfy himself with the authenticity of financial accounts prepared for a fixed period and finally report that the balance sheet exhibits a true and fair view of the state of affairs of the concern, the profit and loss account reveals the true and fair view of the profit or loss for the financial period, and the accounts have been prepared in conformity with the law*".

In short, auditing involves conducting of an investigation and based on that preparing and submitting a report.

DIFFERENCE BETWEEN BOOK-KEEPING, ACCOUNTANCY AND AUDITING

In order to understand the real nature and scope of auditing, it would be necessary to understand the difference between "**Book-keeping**", "**Accountancy**" and "**Auditing**".

Difference between Book-keeping and Auditing

The expression book-keeping denotes the recording of business dealings in a set of books. It involves the initial part of accounting involving recording of all transactions, journalising, posting and balancing.

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OBJECTS OF AUDITING

The main object of auditing is to verify the accounts and to report whether the Balance Sheet and Profit & Loss account have been prepared as per the Companies Act and whether they show true and fair view of the state of affairs of the concern. Besides, there are certain subsidiary objects also to conduct an audit. They are as follows:

1. Detection and Prevention of Errors.
2. Detection and Prevention of Frauds.

The various objects of an audit as shown in Fig. 1.1 are detailed below.

I. Primary Objects

There are two objectives, which are considered as chief objective of auditing. They are as below:

1) To see whether the Financial Statements are Prepared in Conformity with the Law

Business concerns prepare Balance Sheet to portray their financial position. They also prepare Profit & Loss Account to disclose the operating results of the period covered in the statement. These statements are submitted to the auditor for checking and comment. He checks the accounts with utmost diligence and care and also with professional competence. He verifies the accounts as to whether they are prepared as per the recognised accounting policies and practices, and also in conformity with the relevant statute.

2) To see whether the Financial Statements Reveal the True and Fair View of the State of Affairs of the Business Concern

Auditor checks the financial statements submitted to him as to whether the facts given in Balance Sheet and Profit & Loss account are true. Based on the checking he forms an independent judgement and opinion about the reliability of accounting records and true and fair view of financial state of affairs and working results.

II. Secondary Objects

The secondary objectives as depicted in Fig. 1.1 are detailed hereunder.

1) Detection and Prevention of Errors

Generally, errors arise out of the innocence or carelessness on the part of those responsible for the preparation of accounts. Sometimes, errors may be the outcome of fraudulent manipulation of accounts. Therefore, the auditor must pay particular attention to every error. The following are the various types of errors:

1. Clerical Errors: Clerical errors are those that are committed in posting, totalling and balancing. Such errors may again be sub-divided into two namely,

1) **Errors of Omission:** The errors of omission arise when a transaction is wholly or partly omitted from being properly recorded in the books. Usually, it arises due to the mistake of clerks. When a transaction is totally omitted from the books, it is called "**Complete Omission**". It will not affect trial balance and hence becomes more difficult to detect. This type of errors can be detected by careful scrutiny. Omission of entering purchases or sales entirely resulting in complete omission of both aspects of an entry, omitting the entry for charging depreciation in the books, rent outstanding for the 12th month has not been recorded in the books, etc. can be cited as examples here. Due to

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mistake, carelessness or oversight clerks may omit to enter these transactions totally. They are unintentionally made. Hence can be detected only by careful checking and verification. On the other hand, when a transaction is partially recorded, it is called "**Partial Omission**". Such kind of errors may affect trial balance. They can be easily detected because of the disagreement of the trial balance. Omission of cash receipts/cash payments to be posted to ledger from cash book, entry for sale omitted from the account of the customer, total of sales day book omitted to be posted to sales account, etc. can be cited as examples here. In all these cases, as only one aspect has been omitted it will affect the trial balance and the omission will be easily detectable.

Some of the errors of omission are easily detectable. For example, if the number of rent or salary entries for a year is less than 12, the auditor can easily locate the omission. The errors of omission whether intentional or otherwise, will affect the profit or loss of the year.

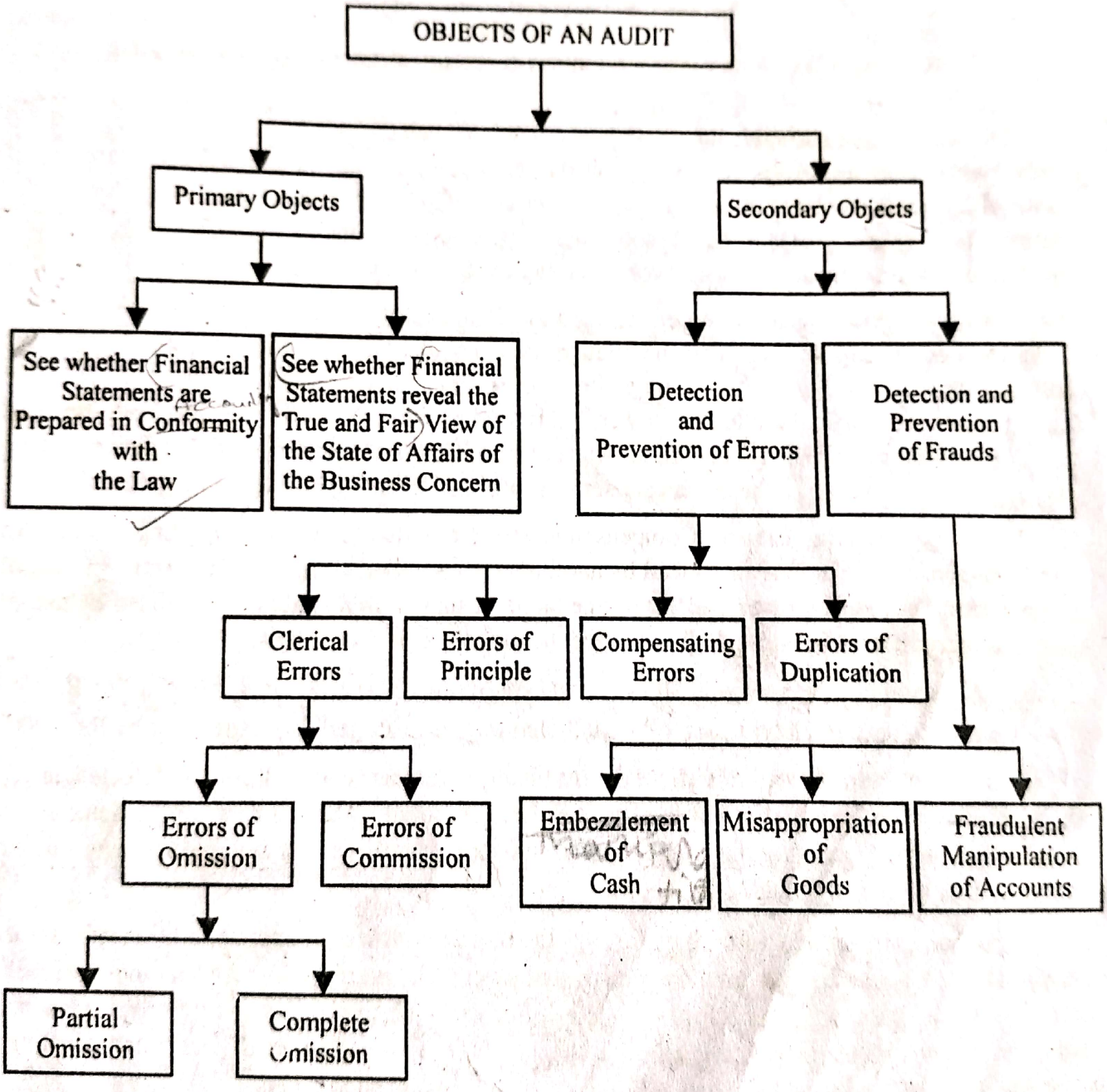


FIG. 1.1 – OBJECTS OF AN AUDIT

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2) **Errors of Commission:** Sometimes, entries are made in the books of original entry or ledger incorrectly either partially or wholly, such errors are called errors of commission. Usually, these errors arise due to negligence in recording of transactions in the books of accounts. Such errors may or may not affect the Trial Balance, Profit & Loss Account, and Balance Sheet. They may be intentional or otherwise. Following are the examples of errors of commission:

1. A sale of Rs.500 is entered in the sales book as Rs.50 (i.e., Incorrect Recording). It does not affect trial balance.
2. Sale of Rs.100 may be written as Rs.10 to the debit of the customer's account, thus debiting Rs.90 less than the real figure (i.e., Incorrect Posting). The effect of this erroneous posting on the Trial Balance would be that the debit side would be short by Rs.90 and it would show a difference.
3. The balance of Rs.125 on the debit of an account may be carried forward to the debit column of the Trial Balance as Rs.115 or Rs.135 or Rs.250, and even Rs.125 may be written to the credit column of the Trial Balance, thus entering the correct figure against this account but in the wrong column (i.e., Errors in Carrying Forward Totals to Trial Balance).

2. Errors of Principle: Errors of principle arise when the entries are recorded against the fundamental principles of accountancy. Wrong allocation of expenditure between capital and revenue, valuation of assets against the principles of book-keeping, providing inadequate depreciation, wrong provision for doubtful debts, ignoring the outstanding assets and liabilities, posting transactions to wrong class of accounts, etc. can be cited as examples for errors of principle.

Such errors can be committed either intentionally or unintentionally. If they are committed intentionally, the object here is to manipulate the accounts with an ultimate purpose of either inflating or deflating the profits. As they affect the Profit & Loss Account and Balance Sheet, the auditor must pay particular attention towards this kind of error. They are not disclosed by Trial Balance or by routine checking. In order to detect them, auditor has to carry out independent searching and exhaustive scrutiny, as these are very serious mistakes affecting business to a great extent.

3. Compensating Errors: Compensating errors are also known as offsetting errors. An error compensated or counter balanced by another error is called compensating error. In case of compensating errors, the adverse effect of one on debit side or credit side is neutralised by that of another on credit or debit side. Following are the examples of such errors:

1. A's account is debited with 100 short and credit side of his account is under cast by Rs.100.
2. Sales ledger is under cast by Rs.1,000 and purchase ledger also under cast by Rs.1,000.

Compensating errors will not affect the trial balance and as such, will not be detected easily. These errors may or may not affect the Profit & Loss Account. These errors can be detected by checking the totals, posting and casting. A thorough and exhaustive preparation on the part of the auditor will help to detect such errors.

4. Errors of Duplication: Errors of duplication arise when an entry in a book of original entry has been made twice and has also been posted twice. These errors do not affect the agreement of Trial Balance, hence can't be located easily. For example, invoice sent in duplicate entered twice in the books and posted twice in the ledger. Only thorough checking and comparing of vouchers with entries in the books of original entry will reveal such errors.

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2) Detection and Prevention of Fraud

Various terms like fraud, embezzlement, defalcations, and misappropriations are often used in a confused way. Hence it is desirable to understand the exact meaning of each term. Fraud may be referred to intentional misrepresentation of financial information by one or more individuals among management, employees, or third parties. It may involve-

1. manipulation, falsification, or alteration of records of documents.
2. misappropriation of assets.
3. suppression or omission of effect of transactions from records or documents.
4. recording of transactions without substance.
5. misapplication of accounting policies.

The term is defined by **Kohler** in the **"Dictionary for Accountants"** compiled by him. Other authors also define the term fraud. We shall now see some of the definitions for the term fraud.

Definition of L. Kohler: "*Fraud is the successful practice of deception (deceiving) of artifice (skillfully) with intention of cheating or injuring another*".

Definition of the AICPA: The **AICPA**, in its **Statements on Auditing Standards** declares, "*Fraud encompasses an array of irregularities and illegal acts characterised by intentional deception*".

Definition of IFA: The **International Auditing Guidelines** (IAG) of the **International Federation of Accountants**, defined the term fraud as follows:

"*Fraud is the intentional misrepresentation of financial information by one or more individuals among management, employees or third parties*".

Characteristics of Fraud

The **Institute of Internal Auditors** beautifully explains the characteristics of fraud as follows:

1. Fraud consists of an array of irregularities and illegal acts characterised by intentional deceiving. People inside the organisation or outside the organisation can commit it. Similarly, it may aim to benefit the organisation or to benefit some other person at the expense of the organisation.
2. Fraud committed for the benefit of the organisation involves exploitation of an unfair or dishonest advantage. Such frauds generally produce the desired benefits but involve deceiving of an outside party. The persons who commit such frauds for the benefit of the organisation are also benefited indirectly. For example tax frauds, intentional failures to disclose significance information to impress outsiders about the financial position of the company, intentional improper valuation of the assets and liabilities, illegal contribution to political parties, etc. The people in the helm of affairs commit these frauds. Hence the auditors will not be called upon to probe into such irregularities generally.
3. Fraud committed to the detriment of the organisation, generally for the benefit of an employee or an outsider, another firm either directly or indirectly. Examples are: acceptance of bribes, diversion of a potentially profitable transaction which will produce some profit to the company in favour of another persons or another firm or to an outsider. By using inside information these frauds are committed. Some of the frauds committed by utilising inside information cannot be penalised even if it is detected. Other frauds like embezzlement, defalcation, misappropriations, etc. also come under this category but the parties involved can be punished. The auditors are generally asked to investigate into these types of frauds and report thereon.

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Forms of Fraud Committed Against the Interest of the Company

It is already stated that the frauds take variety of forms and committed cleverfully in a variety of methods. The most usual forms of frauds committed against the interest of the company are:

1. Acceptance of bribe.
2. Using inside information against the interests of the company.
3. Embezzlement or misappropriation of the firm's assets for personal use.
4. Manipulation of accounts.
5. Improper payment for goods not supplied.
6. Submission of claims for services, which are not actually rendered to the organisation.

These types of frauds are a financial loss to the company. Hence in most cases the auditors are called upon to investigate into these types of frauds. Moreover, it is also desirable to prevent such frauds before being committed.

Detection of fraud is one of the important duties of an auditor. In fact, auditing is conducted with a view to detect fraud wherever it is suspected. Frauds may be divided into three categories as below:

1. Embezzlement or Misappropriation of Cash.
2. Misappropriation of Goods.
3. Fraudulent Manipulation of Accounts.

1. Embezzlement or Misappropriation of Cash: Cash is misappropriated by theft of cash receipts, petty cash, cheques and other negotiable instruments and showing fictitious payments to workers, creditors, purchasers, etc. Misappropriation of cash is an easy affair. A person with a little effort can misappropriate cash. There is a greater possibility of embezzlement of cash in big business houses where there is not much direct contact between the owners of the business and the person handling the cash. Particularly when a person is not subject to any form of check, such person will have number of opportunities to commit frauds. However, in case of small business concerns, the possibility of frauds remaining undetected is remote because of close and direct contact between the owner and the person handling the cash. Hence in big business concerns, strict control should be exercised over the receipt and payment of cash so that the work of one clerk is automatically checked by another clerk. Such a system is known as "**Internal Check System**". It shall be dealt elaborately in a subsequent chapter.

Following are the some of the examples of misappropriation of cash-

1. Omitting to enter cash, which has actually been received.
2. Entering less amount than what has been actually received.
3. Omitting to record sales and taking the money received from customers for such sales.
4. Concealing money received from first customer and entering in his account when the cash received from second one and so on. This is popularly known as teeming and lading.
5. Making fictitious entries for the items like discounts, returns, bad debts, etc., in the accounts of customers.
6. Recording fictitious purchases and misappropriating the cash involved.
7. Suppressing credit notes received from creditors for purchase returns and discount.
8. Misappropriating money recorded as wages in the wages sheet by entering dummy names of workers therein.

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2. Misappropriation of Goods: Sometimes, an employee may take away the goods of the company for his personal use. It is known as misappropriation of goods. Goods are generally misappropriated by actual theft of valuable goods and issuing of fictitious credit notes to customers. Misappropriation of goods is very difficult to detect when the goods are less bulky and are of higher value.

Fraud in respect of goods cannot be easily detected. Only the efficient system of record keeping, periodical checking, internal check, and adequate security arrangements will be helpful to avoid misappropriation of goods. Hence, the auditor has to check thoroughly the inward and outward register, invoice, sales memo, audit notes, etc. to detect this kind of fraud.

3. Fraudulent Manipulation of Accounts: Generally, upper level management commits this type of fraud in order to mislead certain parties both internal and external to the organisation. Such frauds normally involve large amounts. They are committed intentionally. So they are very difficult to be detected. There are two types of motives behind such manipulations. They are as below:

1) Inflating the Profits: If profit is inflated, it benefits the company, higher official, etc. in the following ways:

1. The manager may get more commission if it is calculated on the basis of profits earned.
2. To sell the shares he holds in the company at a high price by declaring higher dividends.
3. The confidence of shareholder is maintained on the manager.
4. The financial position of the business is shown better than what actually it is.
5. When the company is in the process of issuing shares to the public more subscribers for such shares can be attracted.
6. To show credit worthiness to creditors, bankers, etc.
7. To declare higher rate of dividend.

2) Deflating the Profit: Showing less profit benefits the company as well as the executives in the following ways:

1. To give a wrong impression about success of the business to competitors.
2. To reduce/avoid payment of income tax.
3. To purchase shares at a lower price in the market.

Usually, the following devices are resorted to for falsification of accounts:

1) Inflating or suppressing expenses or purchases.
2) Inflating or suppressing sales or other incomes.
3) Over or under valuation of stocks.
4) Providing less depreciation or more depreciation or not providing for any depreciation.
5) Under or over valuation of assets and liabilities.
6) Utilising secret reserves during a period when the concern has made less or no profit without disclosing that fact to the shareholders.
7) Charging capital expenditure to revenue account or *vice versa*.
8) Showing a more prosperous position than what actually it is. This is what is called window dressing. By this process the Balance Sheet is made to show a state of affairs that is far better than the normal position of the business.
9) Failing to adjust outstanding liabilities or prepaid expenses.

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Selection of a particular audit technique in a given situation depends on the types of propositions to be reviewed and the nature of evidence available in support of the propositions. Techniques of auditing need to be continuously updated as the scope of auditing gets broadened. Fig. 1.2 shows the techniques that are suggested by SAP 5 to be applicable under different circumstances.

1. **Vouching:** In the words of **Taylor** and **Ferry**, "*Vouching can be defined as an examination of the evidence, offered in substantiation of the entries in the books including in such examination, the proof so far as possible that no entries have been omitted from the books*".

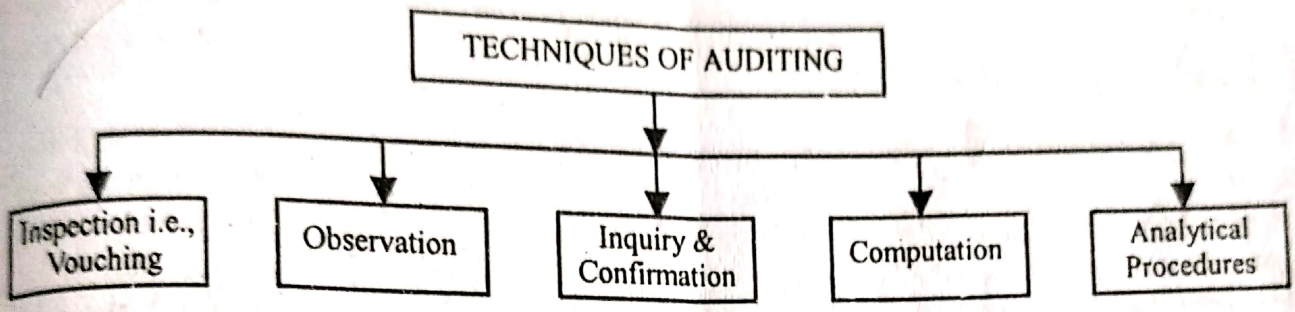


FIG. 1.2 – TECHNIQUES OF AUDITING

The success of an audit depends upon the intelligence with which vouching is done. It does not merely mean the inspection of receipts with cash book records. It includes the examination of the transaction along with its documentary evidence in order to determine its authenticity and validity. In order to achieve it, the auditor may have to go even behind the recorded information so as to eliminate the possibility of any fraud. The auditor can determine the real state of affairs only by examining the external evidence carefully. Thus, vouching enables an auditor in establishing the truth of entries appearing in the books of account. It is indispensable in order to ascertain the genuineness of the entries through their sources as to whether- (i) they are in conformity with the general nature of the business, (ii) they have been duly authorised, and (iii) they have been correctly recorded in the books of accounts. Vouching establishes not only the regularity and validity of the transactions, but also the real accuracy of the records.

2. **Observation:** The data or evidences collected can give the auditor some insight over the functioning of the systems. By observation, he ascertains how the systems work in practice. Moreover, this procedure enables the auditor to acquire a thorough knowledge of the systems. Observation enables an auditor to evaluate the efficiency and effectiveness of the system followed by organisation. For example, observing the stock taking work carried by the staff of the client, procedure followed in receipt or issue of material, physical lay out of the plant, storage of equipment and invention, physical inventory procedures, co-ordination and utilisation of personnel and other kinds of operations etc.

3. **Inquiry and Confirmation:** Some information due to their complex nature requires further clarification. Inquiring is a procedure by which information is obtained orally for exploring the facts that are recorded or developed from other sources. When the auditor feels that the information collected needs further clarification he should call the concerned person and seek the required clarification. The auditor has every right to seek or call for many explanations, which in his opinion is necessary for the proper conduct of the audit. This right to seek explanation is conferred upon the auditor by statute.

On the other hand, confirmation is a technique to contact responsible officials through interview and to open communication with the outside parties for ensuring that the transactions are authentic,

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valid and accurate. Documents prepared by independent third parties are generally more reliable. If such documents reach the auditor directly and not without passing through the hands of the client's staff, their authenticity is further increased. Originally the confirmation procedure was adopted only in case of balances due from the debtors and creditors. Recently the auditors have extended the procedure in cases where the internal control system is weak or the documents are missing. For example, the auditors follow this technique to consider the unrecorded liabilities and the validity of account balances.

Both inquiry and confirmation can take place either orally or in writing confirming the balances of debtors shown in the account statements with the debtors of the organisation can be cited as a best example here.

4. Computation: Computation refers to the making of appropriate calculations and verifying the accuracy of the accounting records. For example, the auditor may compute the interest on loan borrowed from a financial institution taking into account the amount of loan, rate of interest agreed, date of the loan, etc. to verify the accuracy of the interest paid by the organisation. Similarly, he may compute the depreciation to be charged for the year by considering the value of the asset, date of purchase, rate of depreciation, etc.

5. Analytical Procedure: Analytical procedure is followed to ensure consistency of accounting methods and evaluate the efficiency of the management by comparing results of several years. Following are the some of the analytical procedure followed by an auditor for the purpose:

1. Reconciliation - The differences in figures are reconciled and causes for their existence are brought to light.
2. Ratio Analysis - Ratios express the relationship between the two figures such as sales and net profit, gross profit and sales, profit and investment, debt and equity, etc. Calculation of ratios enables judging the consistency of the financial statements as a whole.
3. Variance Analysis - Variance analysis is the crux of standard costing system. Variance is the difference between the standard cost and the actual cost. The ultimate aim is to control the costs by fixing the responsibilities for variances. This is done by analysing variances for their causes.

Analytical procedure is useful in decision making also. The following techniques are adopted for the purpose-

1. Marginal Costing – Marginal costing is the most useful technique, which guides management in pricing, decision-making and assessment of profitability. It classifies costs into fixed and variable ones, and explains managerial problems on the basis of difference between sales and variable costs. It reveals the inter-relationship between cost, volume of sales, and profit.
2. Standard Costing – Standard costing is an effective management tool for planning, co-ordination, and control of business. Essentially, it is a technique of cost control. It involves the preparation and use of standard costs, their comparison with actual cost, and the analysis of variances to their causes and points of incidence.

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Depending upon the nature of business and prevailing conditions, an auditor selects the suitable techniques. Whenever the circumstances demand, he changes the techniques also to suit the changed situation, which enable him to conduct the audit efficiently.

QUALITIES AND QUALIFICATIONS OF AN AUDITOR

An efficient auditor must posses certain general qualities besides statutory qualification, so that he can carry out his work efficiently and smoothly. The qualities of an auditor as classified below are presented in Fig. 1.3.

1. Professional Qualification i.e., Statutory Qualification.
2. Professional Qualities i.e., Personal Qualification.
3. Personal Qualities i.e., General Qualities.

They are detailed below:

1. Professional Qualification i.e., Statutory Qualification

In the case of sole trading concern and partnership the law has not prescribed any qualification for an auditor. However in the case of auditors of joint stock companies, the auditor must be a Chartered Accountant within the meaning of Chartered Accountant Act, 1949. He must pass Chartered Accountant (C A) examination conducted by the Institute of Chartered Accountants of India (ICAI). To be entitled to practice, a chartered accountant should obtain a certificate of practice from the council of the ICAI on payment of a prescribed annual fee.

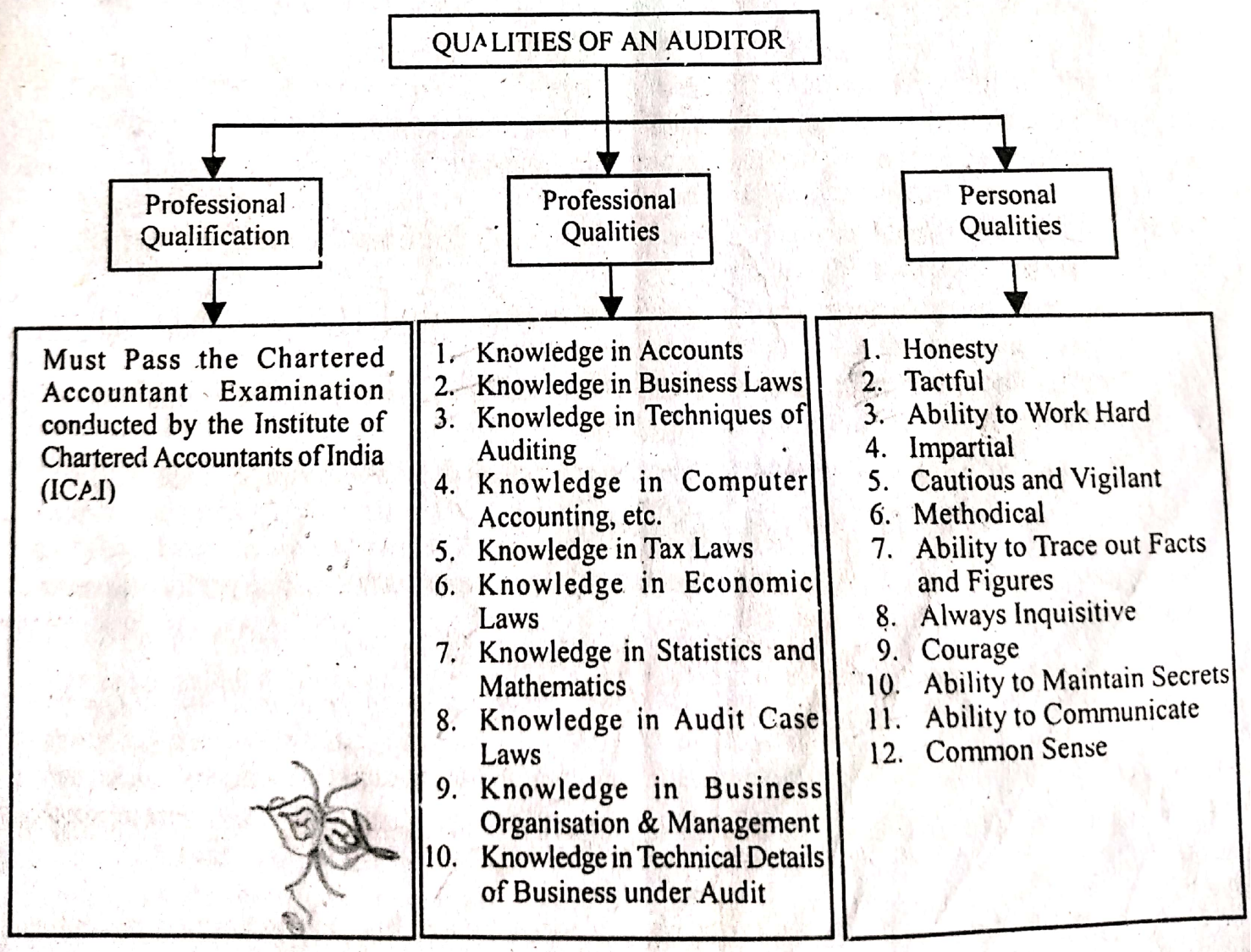


FIG. 1.3 - QUALITIES OF AN AUDITOR

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There are two categories of members of the ICAI such as- Associates, and Fellows. A person becomes an Associate Member of the Institute as soon as his name is entered in the Register of Members maintained by the Institute. This entitles him to use the letters A.C.A. after his name. An associate in continuous practice in India for at least five years under any other associate who has been a member of the Institute for five years and possesses such qualifications as prescribed by the Council of the Institute can be enrolled as a Fellow of the Institute and is entitled to use the letters F.C.A. after his name.

2. Professional Qualities i.e., Personal Qualification

The professional qualities required for auditors are many and are of varied in nature. They are required for the successful performance of audit work. They are as follows:

1. The auditor must have a complete and thorough knowledge of the principles, theory and practice of accountancy. The auditor must be familiar with the different system of accounting and their aspects. He must be well versed with the all branches of accounting. He should be aware of the latest developments in the field of accounting.
2. He should have a thorough knowledge in various legislations regulating business such as Companies Act, the Indian Partnership Act, Banking and Insurance Act, Sale of Goods Act, Foreign Exchange Management Act, the Indian Contract Act, etc.
3. The auditor should have a thorough knowledge of the techniques of auditing. He should be fully aware of new changes and developments in the principles and practice of auditing.
4. The auditor must be familiar with the computer accounting and other automatic machine devices used in the office.
5. In addition to the knowledge of commercial laws, an auditor should have a thorough knowledge of the various provisions relating to income tax wealth tax, VAT, gift tax, etc.
6. The auditor should be familiar with the principles of economics and economic laws because a business has to work, within some specific economic laws and social environment and its influence is visible into business.
7. The auditor should have knowledge in statistics and mathematics, which will help him to deal with complicated problems.
8. He must study important judgements in audit cases, which will help him to define the duties, responsibilities, and liabilities of an auditor.
9. An auditor should have a good knowledge in business organisation and financial administration, and industrial management.
10. The auditor should have knowledge on the technical details of business under audit.

3. Personal Qualities i.e., General Qualities

Individual qualities ate the essential monitors of a successful auditor. The personal qualities that are needed for an auditor are as follows:

1. **Honesty:** An auditor must be honest in his work if he has to carry out his duties successfully. He has to maintain a good moral standard.
2. **Tactful:** The auditor should be tactful in dealing with the client's staff.
3. **Ability to Work Hard:** The auditor must have a painstaking attitude and willingness to work hard.
4. **Impartial:** The auditor should not be influenced by any bias in discharging his duties. He should be impartial.

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5. **Cautious and Vigilant:** An auditor must be vigilant in his work. He should always proceed with his eyes open and be alert.

6. **Methodical:** He must perform his duties methodically, and should be thorough, and complete in his work.

7. **Ability to Trace out Facts and Figures:** Auditor should posses a realistic attitude towards his work. He should be able to trace out facts and figures.

8. **Always Inquisitive:** The auditor should not be suspicious. He should always be inquisitive. He should not adopt an attitude of suspicion.

9. **Courage:** The auditor should be bold enough to discharge his duties. He must not certify what he does not believe to be true.

10. **Ability to Maintain Secrets:** The auditor should have the ability to maintain secrets and should not disclose the secrets of his client to anybody.

11. **Ability to Communicate:** An auditor must have the ability to prepare audit report correctly and forcefully, precisely, concisely, and clearly.

12. **Common Sense:** An auditor should posses a good common sense. As stated by **Spicer and Pegler** " *Last but not least, the auditor should have a full share of the most valuable commodity - common sense*". But common sense is normally very much uncommon in man.

Over and above the statutory and professional qualification, the auditor has to observe certain code of conduct and professional ethics. This professional ethics of an accountant would signify his behaviour towards his fellows in the profession and other professions towards members of the public. Responsibility and attitude of professional auditor can gain public confidence and trust.

Further, in the digital age, majority of the business transactions are done on line. Accounts are maintained on computer. The Electronic Data Processing (EDP) systems are in operation for maintenance of accounts. No primary data are used for recording transaction. Thus the auditor has to acquire the knowledge of EDP System. He himself must be competent to face the challenges of new digital business world of E Governance and E Commerce.

STANDARDS OF AUDITING

In order to ensure consistent, objective and reliable audit services, a large number of standards have been developed over a period of time. These are called Generally Accepted Standards of Auditing (GAAS). The auditor should have a thorough understanding of these standards in order to conduct an audit effectively. So the studies the professional pronouncements on auditing which indicate the collective view of the profession on principles and techniques of auditing and their application in various auditing situations. This part contains a discussion on the standards of auditing.

Professional Pronouncements on Generally Accepted Auditing Standards

Professional bodies of accountants in various countries have issued pronouncements on generally accepted auditing standards. They discuss various auditing standards primarily in the context of independent financial audits where the auditor is required to express an opinion on financial statements audited by him. Standards have also been developed for related services such as limited review of financial statements, agreed-upon procedures, and compilation of financial statements. Pronouncements are also being issued on other types of audit namely, internal audit and cost audit.

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CLASSIFICATION OF AUDIT

2 CHAPTER

Introduction - Classification on the basis of the Organisation - Classification Based on the Method of Performance.

INTRODUCTION

Audits are of many types. Generally, they can be classified into two broad categories. They are as follows:

1. Classification on the basis of the organisation.
2. Classification on the basis of the method of performance.

Each of the above can be further classified into so many types as shown in Fig. 2.1. They are detailed below.

1. CLASSIFICATION ON THE BASIS OF THE ORGANISATION

Based on the form of organisation, audit can be further classified into four types, which are as below:

1. Private Audit.
2. Audit under Statute.
3. Government Audit.
4. Internal Audit.

We shall now discuss each one of them briefly in the preceding page.

1. Private Audit

Private concerns also differ in their form of organisation. So they can again be classified into four types as follows:

1. Audit of Sole Trading Concerns.
2. Audit of Partnership Firms.
3. Audit of Individuals.
4. Audit of Other Private Institutions.

Though audit of accounts of private concerns is not compulsory, from 1985 onwards, if a private concern's turnover exceeds Rs.40 lakhs, audit has been made statutory. We shall now discuss briefly audit of each of these forms of organisations.

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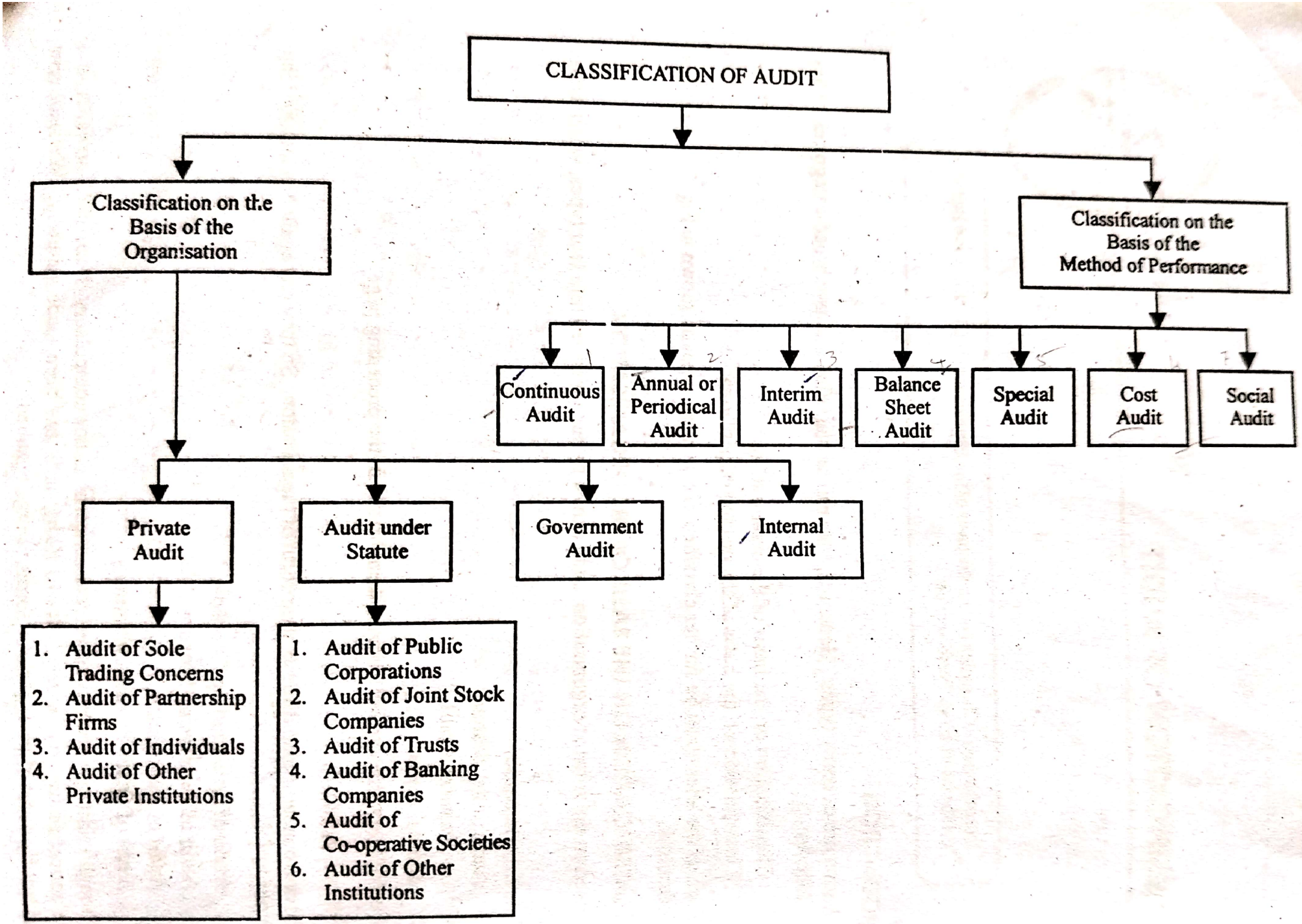


FIG. 2.1 - CLASSIFICATION OF AUDIT

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1) Audit of Sole Trading Concerns

In case of sole trading concerns, there is no legal compulsion to audit their accounts. But now-a-days it has become customary to have their accounts audited, especially those traders whose area of operations and the volume of business are very large. Sole trader will decide about the scope of audit and appointment of auditor. The auditing work will depend upon the agreement of audit and the specific instructions given by the proprietor. Such an auditor must get clear and unambiguous instructions in writing by his client as to what he has to do and how he has to proceed. In future if auditor is held responsible for negligence, he can protect himself by producing the agreement of audit.

In case of sole trading concerns, sometimes auditor is appointed to prepare the accounts; sometimes he is asked to audit the accounts. Therefore, it is very important that he must know his exact duty and the nature of the work he is called upon to do. If he is called upon to perform the full audit, he must see that the accounts are properly prepared and that the Balance Sheet is correct. To sum up, he must act strictly as per the instructions of his employer.

Advantages of Audit to a Sole Trader

The sole traders get the following benefits from the audited accounts:

1. The trader is assured of his accounts being properly maintained and his expenditures properly vouched.
2. He is also assured of not being defrauded by any of his employees or agents. He can also come to know if any frauds committed by any of his employees.
3. Audited accounts are considered reliable for income tax purposes, wealth tax purposes, estate duty, and other claims.
4. Audited accounts may become the basis for settlement of final accounts.
5. Comparing of figures of different periods is made possible.

2) Audit of Partnership Concerns

In case of partnership firms also, audit is not compulsory. But as there are many advantages of getting the accounts; audited, now-a-days many firms make a provision for audit in their Partnership Deed. In partnership firms, the accounts are audited in the interests of the partners, and so considered as most desirable.

In case of partnership firms, the scope of the duties and responsibilities of the auditors are wholly determined on the basis of the agreement between the firm and the auditor. A Chartered Accountant engaged by the firm to prepare accounts will not incur the liabilities of an auditor while certifying the accuracy of the accounts. In his certificate he will mention as to- the capacity in which he has acted, whether he has been able to obtain the necessary information and explanation, whether the records appear to be reliable and adequate as to the nature of the business, and whether the client imposed any limitations on the conduct of the audit.

Advantages of Audit to a Partnership Firm

A partnership firm may be benefited in the following respects if it gets its accounts audited by the qualified auditors:

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1. Partners can get an unbiased and independent opinion on the true state of affairs of the financial position of the firm.
2. Auditing will help in the maintenance of up-to-date accounts as well as in the detection and prevention of errors and frauds. It will ensure the drawing up of the final accounts as per the terms and conditions of the partnership agreement.
3. The audited accounts provide a sound and unimpeachable basis for the settlement of accounts amongst the partners. Especially to the sleeping partners it will be of great help.
4. At the time of admission, retirement, or death of a partner, and sale of business, the valuation of goodwill and the settlement of accounts become very easy.
5. Audited accounts are very much reliable and help the firm in negotiating loan from the financial institutions, and also for the assessment of taxes.

If an auditor is appointed to audit the accounts of a firm, he must thoroughly analyse the provisions of the Partnership Deed pertaining to the following:

1. Nature of the business.
2. Accounting year of the firm.
3. Capitals contributed by the partners.
4. Profit sharing ratio agreed between the partners.
5. Rates of interest on capital and drawings.
6. Interest on loans from partners.
7. Salaries or remunerations or commissions if any allowed to the partners.
8. Borrowing powers possessed by the partners.
9. Basis of valuation of goodwill and its treatment in the books of accounts.
10. Settlement of accounts at the time of dissolution.
11. Other limitations on the powers of the partners.

If no such specific provisions as mentioned above are specified in the Partnership Deed, the auditor must ensure that the provisions of the Indian Partnership Act, 1932 are strictly complied with.

3) Audit of Individuals

There are other individuals like estate managers, rent collectors, investors, etc. who derive large income and incur heavy expenses to earn such incomes. They appoint accountants to prepare and maintain accounts. They may appoint auditors to audit their accounts and to verify their accuracy. Auditing of their accounts will relieve them from the harassment of the income tax authorities.

In case of audit of accounts of these people, the person so appointed as an auditor must get clear instructions from his client as to what he is expected to do. His scope of work will depend upon the agreement entered into with his client.

Advantages of Audit of Individuals

The individuals get the following benefits from the audited accounts:

1. Audited accounts are generally taken as correct by income tax authorities. In that way, auditing of accounts helps in the assessment of income for income tax purposes.
2. The audited accounts assure the individuals as to the accuracy of accounts.
3. It keeps a moral check on the employees of the accounts department, as they know that the auditor would verify whatever they record.
4. The individual can know the true income from various sources and value of his assets.

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4) Audit of Other Institutions

There are institutions other than a company, a partnership firm or a sole proprietorship concern, which are not meant for earning profits such as, clubs, hospitals, libraries, colleges, schools, etc. Such institutions also require the services of an auditor whose scope of work is defined by the appointment letter. They are increasingly realising the significance of a scientific audit and hence, auditors are regularly being appointed especially in big institutions.

The primary objective of such audit is to detect error or frauds committed by the staff. At times these institutions avail grant from Government, International agencies, etc. In such cases, audit of utilisation of such grants becomes essential. If the amount involved is large, the government may send its auditors to conduct the audit.

2. Audit under Statute

In case of certain concerns, audit has been made compulsory. They are as below:

1. Public Corporations.
2. Joint Stock Companies.
3. Trusts.
4. Banks.
5. Co-operative societies.
6. Other Institutions.

1) Audit of Public Corporations

Public corporations such as Reserve Bank of India, the Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, LIC, UTI, etc. come under this category. They are established and regulated under the relevant Acts passed for the purpose. Though the audit of these institutions is made compulsory they also fully recognised the significance of a professional audit. The powers, duties, and liabilities of the auditors are also well-defined and fixed by the relevant statutes.

2) Audit of Joint Stock Companies

Joint stock companies are established both in public sector as well as private sector. The companies, which are formed in public sector, are called Government companies. The companies, which are formed in private sector are of two types such as- private companies and public companies. The audit of the books of accounts of all types of joint stock companies in India is made compulsory under the Companies Act. For the first time, the Indian Companies Act, 1913 made it legally obligatory for joint stock companies in India to get their accounts audited by an independent professional accountant. Thereafter the Companies Act, 1956 and the subsequent amendments made to it have made tremendous changes in the rights, duties, liabilities, powers, etc. of an auditor. He should be a qualified auditor as laid down under section 226 of the Act. They are dealt in a detailed manner in a subsequent chapter.

3) Audit of Trusts

Trusts are formed under the Indian Trusts Act. They are usually created for the benefit of the weak and helpless persons like widows, minors, etc. who are not in a position to have access to and understand the accounts of such trusts. The trustees are appointed to manage and look after the property and business of the trust. The trustees are made responsible to maintain accounts.

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They prepare the accounts of trust as per the terms and conditions of the trust deed. The income of the trust is distributed to the beneficiaries. In case of trusts, there are more chances of frauds and misappropriation of incomes and properties. Various provisions are being made in the trust deed as well as in the Public Trust Act, which provide that the accounts of the trust are to be audited by a qualified auditor. Further, it is provided that if its income exceeds a certain level, its accounts are to be audited as per the requirements of the Income Tax Act. The audited accounts of the trust ensure true and fair view of accounts of trust.

4) Audit of Banking Companies

In our country, mostly banks are established in the form of a Joint Stock Company and are registered under the Companies Act. So their accounts are also subjected to compulsory audit.

5) Audit of Co-operative Societies

In our country, co-operative societies are established under the Co-operative Societies Act 1912. The Act contains various provisions regarding the regulation and working of these societies. Some States follow it without any change, whereas others have brought out certain changes in it. The auditor of a co-operative society should have an expert knowledge of the Act under which the co-operative society is functioning. He should also study the byelaws of the society. The Companies Act is not applicable to the co-operative societies.

The co-operative societies audit is a state controlled audit. Co-operative department of the State Government shall conduct the audit of co-operative societies. However, societies are also allowed to appoint the auditors but subject to the confirmation of the Co-operative Department of the State. The auditors of the co-operative societies need not be qualified Chartered Accountants. They are usually the officials of the co-operative department. Sometimes external auditors are also allowed by the department from a panel of Chartered Accountants. The scope of the work of the auditors of co-operative societies is slightly more than the auditors of joint stock companies. Audit of co-operative societies is something more than a purely financial audit. In this case, in addition to the reporting on the financial position of the company, the auditors are also asked to report on certain additional matters like the element of co-operation present amongst the members of the society, the working of the society, causes of loss, if any, and suggest steps to avoid it. It is also the duty of the auditor to report if the society has committed any breach of its byelaws. He should also discuss the financial condition of the society in his report in a detailed manner.

6) Audit of Other Institutions

Besides the institutions mentioned above, public utility concerns like Electricity Board also should get their accounts audited as per the provisions of respective Acts.

3. Government Audit

Government audit is applicable to Government departments and departmental undertakings. Government of India maintains a separate department known as Accounts and Audit Department. Comptroller and Auditor General of India heads this department. In India the President appoints the Comptroller and Auditor General of India under Article 149 of the Constitution, which gives the powers and rights and fixes his responsibility for the audit of Government departments and institutions. Government audit is divided into several branches like Defence, Railways, Posts and Telegraphs audit. It works only for government offices and departments. This department cannot undertake audit of non-government concerns. Its working is strictly according to government rules and regulations.

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Objectives of Government Audit

The objectives of government audit are as follows:

1. To make sure that the expenditure is incurred out of the fund, which the competent authority has sanctioned.
2. To verify that the expenditure of the government department is sanctioned as per the rules and regulations of the department concerned.
3. To see that the expenditure already sanctioned has been incurred by an officer who is authorised to do so.
4. To ensure that the payments have been made to the right persons and they are duly entered in the books on the basis of receipts received from them.
5. To see that the payments have been properly classified into capital and revenue.
6. To check the existence of stock and stores and their proper valuation.
7. To ensure that expenditures have been incurred in the interest of public.
8. To ensure that stocktaking is done periodically and stock registers are maintained up-to-date.
9. To ensure that whether money due from others has been regularly recovered while verifying the receipts.

Difference between Government Audit and Commercial Audit

The points of difference between government audit and commercial audit are given in Table 2.1.

S.No.	BASES	GOVERNMENT AUDIT	COMMERCIAL AUDIT
1.	In charge for the Conduct of Audit	Auit and Accounts Department conducts the audit of government department.	External auditor appointed by the employer shall conduct the audit here.
2.	Type of Audit	Government audit always a type of continuous audit because of the involvement of huge expenditure and large number of transactions.	In commercial concerns, mostly periodical audit is conducted.
3.	Nature of Appointment of Auditors	Auditors are government employees.	They are not the employees of the concerns whose accounts they audit.
4.	Sanction of Audit Department	In most of the government concerns before payment for an expenditure is released the sanction of audit department is a must.	It is not necessary here.
5.	Need for Preliminary Examination of Bills	Treasury officer always makes a preliminary examination of bills before making a payment on government account.	Cashier has nothing to do with audit or preliminary examination while making a payment of expenditure.
6.	Rules & Regulations	Government audit is subjected to the rules and regulations of the concerned department.	It is not so in the case of commercial audits.

TABLE 2.1 - DIFFERENCE BETWEEN GOVERNMENT AUDIT AND COMMERCIAL AUDIT

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4. Internal Audit

According to the classical view, internal audit is an examination of books of accounts, which is conducted by the salaried officials of a business firm known as internal auditors throughout the year. Thus, the scope of internal audit according to this traditional view is limited. But today, internal audit is considered as an effective means of control with wider scope. The internal audit has grown as a separate discipline with a number of objectives and emerged as a control of the last resort. When we go over this subject we come across different meanings of internal auditing attached by different people. The usual meanings to the term are:

1. *"Internal Auditing is an extension to activity of an external auditor".*
2. *"Internal auditing is a tool and technique for a periodical review of organisational systems and procedures arising out of activities within the organisation to ensure over all efficiency".*
3. *"Internal Auditing is the study of accounting and financial aspects directed towards compliance with accounting measures, correctness in accounting data, and detection of fraud".*

A detailed analysis of this type of audit has been made in a subsequent chapter.

II. CLASSIFICATION BASED ON THE METHOD OF PERFORMANCE

On the basis of method of performance, audit can be classified into six types as shown below:

1. Continuous Audit.
2. Periodical Audit or Annual Audit.
3. Interim Audit.
4. Balance Sheet Audit.
5. Special Audit.
6. Cost Audit.

Besides the above, Branch Audit and Social Audit are the other audits, which are specified in the Companies Act. We shall now detail each one of them as shown below.

1. Continuous Audit

A continuous audit is one where auditor's staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals fixed or otherwise, during the currency of the financial year and performs an interim audit. Such audits are adopted where work involved is considerable and have many points in their favour, although they are subject to certain disadvantages.

It involves a detailed examination of all the transactions by the auditor attending at regular intervals say weekly, fortnightly or monthly, during the whole of trading. The checking of accounts goes on simultaneously with the preparation thereof. The auditor is constantly engaged in checking accuracy of the accounts, during the whole accounting period. However, the work of verification of assets and liabilities is left over until the preparation of the Balance Sheet at the end of the accounting period.

Suitability of Continuous Audit

Usually, a continuous audit is suitable in the following cases:

1. Where periodical statements are required frequently.
2. Where final accounts are to be present immediately after the close of financial year.

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3. Where internal check is not effective.
4. Where scope of business is wide.
5. Where business is very large and number of transactions to be checked is numerous.
6. Where cash transactions are more.
7. Where sales are very large and a detailed investigation is required.

Advantages of Continuous Audit

Continuous audit enjoys many benefits. Of them, important ones are detailed below:

1. **Immediate Detection of Errors and Frauds:** Errors and frauds can be detected easily and immediately because auditor checks the accounts at regular intervals and also in a detailed manner. Further the opportunities for complicated frauds are lessened and they can be detected before they attain larger proportions. Early detection makes rectification also easy. As and when errors are detected, steps are also taken for their rectification immediately.

2. **In-Depth Checking:** Under this system, a detailed examination of accounts is possible as the auditor gets one complete financial year for the purpose.

3. **Proper Planning of Audit Work:** Under the continuous audit, auditor can plan his audit work systematically. He can spread his work evenly throughout the year. It helps him in improving his efficiency in the audit work.

4. **Quick Preparation of Interim Accounts:** Some companies have the practice of giving interim dividend to its numbers. In such cases, continuous audit will be of a great help because here interim accounts can be prepared without much delay.

5. **Quick Finalisation of Accounts:** Under continuous audit, audit can be completed quickly, and finally accounts can be presented sooner.

6. **Valuable Suggestions:** In case of continuous audit, auditor remains more in touch with the business. So he is in a position to know the technical details of it and hence can be of great help to the clients by way of making valuable suggestions.

7. **Up-to-date Accounts:** Under continuous audit, efficiency of the staff of the accounts department will increase, which make their work up-to-date and accurate.

8. **Keeps the Audit Staff Busy:** In the case of continuous audit, each and every person of the deputed staff in the particular concern is kept fully busy.

9. **Provides Desired Information Readily:** Under continuous audit the proprietor of the concern may get the desired information duly verified at any time without any difficulty.

10. **Greater Moral Check:** Frequent and surprise visit of the auditor to the business in continuous audit would compel the staff to keep the record up-to-date. It has a good moral check on the dishonest practice because of uncertain intervals clerks are not aware that when the auditor will come.

11. **Up-to-date Accounting Records:** Regular visits of the auditor make the clerks alert to maintain accounts up-to-date.

Disadvantages of Continuous Audit

In spite of the above advantages of continuous audit, there are certain drawbacks of such an audit, which are as under:

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1. **Alteration of Figures:** In case of continuous audit, the auditor checks the books of accounts in several visits. There is a possibility that the figures may be altered and client's staff may tamper books of accounts after the auditor has checked them on previous days.

2. **Dislocation of Client's Work:** The frequent visits of the auditor may cause inconvenience to the staff of the business and the office routine may be dislocated.

3. **Expensive:** Continuous audit may not be suitable for small scale concerns because it involves lot of time, effort and money.

4. **Losing the Continuity of Work:** In continuous audit the audit work is not carried out at one time. So the auditors may lose the thread of work and may fail to seek clarifications of the queries arise in the previous visit. In other words, queries and doubts, which arise at one sitting of the auditor and left over for clearance at next sitting, may be overlooked. He may not be able to pick up the work from the point where he left it at the previous audit session.

5. **Unhealthy Relationship:** Frequent visit of audit staff is likely to establish an unhealthy relationship between the audit and the client's staff. Hence the moral check upon them may be lessened.

6. **Monotony:** Under the continuous audit, the work of the auditor becomes mechanical and auditor's frequent visit may also lead to monotony in work.

Precautionary Measures to Remove the Limitations

The auditor should consider the following precautions in order to avoid and minimise the dangers of continuous audit:

1. The auditor should give specific instructions to the client's staff that they should not make any alteration after the checking of books of accounts is over.
2. The auditor should use secret ticks. He should use different colours to denote specific ticks during the course of checking of the different entries.
3. There is a greater possibility of manipulation in impersonal accounts and so they should be checked only at the end.
4. The auditor should prepare notes and checklists on each visit so that alteration can be avoided.
5. A detailed audit programme should be prepared in a thorough and systematic manner.
6. The auditor should note important totals and balances in his diary at each visit, which can be compared at his next visit.
7. The auditor may rotate the work among his staff in such a way that no audit clerk is allowed to check an account from the beginning to the end.
8. All queries that are not satisfactorily answered and doubts that are not clearly explained during a visit must be noted in the audit notebook. This will help him to peruse the same during the next visit.
9. A senior clerk, who has not participated in the detailed checking of the subsidiary books, should check nominal accounts.
10. Audit work is to be carefully allocated among his staff, so that he can prevent the audit work from becoming monotonous and mechanical.
11. The auditor should not inform the date of his visit in advance. In other words, he should pay a surprise visit.

If the continuous audit is subjected to above mentioned safeguards, it is best suited for big business concerns.

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2. Annual Audit or Periodical Audit

To quote **Spicer and Pegler**, "*A final or completed audit is commonly understood to be an audit which is not commenced until after end of the financial period and is then carried on until completed*".

From the above definition, it is clear that the final audit takes place only after the end of the trading period when all the transactions for the whole year are completely recorded and balanced; Trading and Profit & Loss Account, and Balance Sheet have been prepared. The auditor carries on his audit work continuously till it is completed. The auditor gets hold of the books of accounts, documents, vouchers, bills and full facts relating to the accounting period under review. In this type of audit, the auditor visits his client only once in a year and the audit work is commenced and completed in a single uninterrupted session.

This type of audit is very much convenient and useful for business houses, which are small. For big ones, continuous audit is more useful because the work involved in them is voluminous and hence final accounts cannot be prepared at the close of the financial year.

Characteristics of Annual or Periodical Audit

The basic characteristics of annual or periodical audit are listed down below:

1. In case of annual audit, generally audit work commences after the close of the financial year.
2. Audit work is carried on and completed in a continuous session.
3. Auditor visits the client's office only once in a year and keeps on doing the work until it gets over.
4. It is suitable for small scale concerns.

Advantages of Annual or Periodical Audit

The advantages of annual or periodical audit are as follows:

1. **No Dislocations in the Work of Client:** In case of annual audit, as the auditor visits the client's office only once a year the office work is not unnecessarily disturbed.

2. **Less Chance for Alteration of Figures:** As audit work is done only in a one continuous session, chance for alteration of figures is minimum.

3. **Less Expensive:** It is a less expensive system and suitable for small business houses.

4. **Takes only Reasonable Time:** The audit work can be finished quickly within a reasonable time.

5. **Proper Maintenance of Link in Work:** As audit work is done and completed in a continuous session, link in work can be properly maintained.

6. **Easy Allocation of Work:** In continuous audit, work can be allocated easily according to time schedule.

Disadvantages of Annual Audit or Periodical Audit

Following are the disadvantages of annual audit:

1. **More Chances for Fraud:** Auditor may not be able to check and verify all the transactions. Hence there is every chance that some of the errors and frauds may be left undetected.

2. **Delay:** The audited accounts may not be available immediately after the close of the year. It may cause delay in the declaration of dividends and holding annual general meetings. The decisions of vital importance may be delayed due to the lack of audited and verified information.

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3. **No In-depth Checking:** In annual audit detailed checking of accounts is not possible for the auditor. Thus, there is greater chance of errors and frauds being left undetected.

4. **Unsuitable to Large Scale Concerns:** For large scale concerns, periodical audit is rarely practicable and it is not much popular for them.

Difference between Continuous Audit and Annual Audit

Table 2.2 shows the points of difference between continuous audit and Annual Audit.

S.No.	BASES	CONTINUOUS AUDIT	ANNUAL AUDIT
1.	Frequency of Visits of Auditor	In case of continuous audit, the staff of the auditor frequently visits and checks the accounts of the business.	In case of annual audit, the auditor's staff visits the business only once after the close of the year.
2.	Period of Audit	Audit is conducted periodically throughout the financial year.	Audit is commenced only after the close of the financial year.
3.	Regularity of Audit Staff	Client's staff becomes more efficient and regular.	It may not be so here because client's staff knows well that audit work will start only after the close of financial year.
4.	Time of Verification of Transactions	Immediately after the transaction is recorded, audit staff checks and verifies it.	It is not so here. Audit staff checks and verifies the transactions only after the close of the year.
5.	Cost involved in the Audit	It is very much expensive.	It is less expensive and so economical.

TABLE 2.2 - DIFFERENCE BETWEEN CONTINUOUS AUDIT AND ANNUAL AUDIT

3. Interim Audit

The term interim audit means taking up an audit on an interim date during the currency of the financial year. Some companies follow the practice of declaring interim dividend in the middle of the year. Before declaring an interim dividend, it is usual for companies to consult the statutory auditor who will conduct an interim audit and suggest his opinion. Thus, interim audit is closely related to the statutory audit of an undertaking. The statutory auditor undertakes an audit of transactions before the close of the accounting year. It also involves checking of books of accounts vouchers, and other records directly connected with financial accounting. However while preparing the interim financial statement certain assumptions are made and provisions are also made for them. Some authors call interim audit as first step of the financial audit.

Elements or Objectives of Interim Audit

The major objectives of interim audit are given below. These objectives can also be called as basic elements or the interim audit.

1. **Early Finalisation of Audit Report:** The workload of the financial auditor after the completion of the financial year is considerably reduced. If no interim audit is undertaken, he has

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to verify the whole year's transactions fully and entirely after the completion of the year. It will be a time consuming process and may delay the completion of the final audit report by the statutory auditor. In short if interim audit is undertaken, the financial auditor can complete the annual audit within a short period and submit his report as early as possible.

2. **Scope for Detailed Review:** If the audit is undertaken after the completion of the financial year, the financial auditor cannot spare more time to review the systems and procedures thoroughly. However, if an interim audit is undertaken he can spare more time for examination of routines and procedures. Hence he can ascertain the defects and dependability of the systems and procedures and their continuity.

3. **Scope for in-Depth Audit:** The expression "**In-depth Audit**" or "**Auditing In-depth**" signifies the tracing of the transactions in a sequential step manner to cover the whole process of documentation and accounting right from the initiation of the transaction till its completion. Some authors calls this type of audit as vertical checking and verification covering all the sequences of operations involved in a particular aspect of accounting or even a physical verification. In practice, in-depth auditing is not possible if the transactions are more in number. Particularly when the accounts are audited after the completion of the accounting year, in-depth audit of each and every item is totally impossible. However, if interim audit is undertaken the chances for undertaking in-depth audit of more number of transactions are more. In-depth audit of a more number of transactions during the currency of the accounting year shall ensure more accuracy and reliability of the accounting records.

4. **Detailed Review of Internal Control System:** Internal control is the basic element or foundation for the successful operation of a business enterprise. It is not only concerned with the accounting procedures, approval and other forms of financial management but also embraces various activities of an organisation. In fact, internal control has wider scope and embraces the whole system of control, financial, operational or otherwise established by the management in the functioning of a business, including internal check, internal audit and other forms of control. In this context, the "*Statement of Responsibilities of the Internal Auditors*" issued by the Institute of Internal Auditors, U.S.A. declared, "*It will be pertinent to mention here that the whole foundation of internal auditing is about management control systems*". This statement reveals the importance of internal control to the organisation as well as the internal audit.

Apart from the internal audit, interim audit enables the external auditor to review the internal control systems in detail as to their effectiveness and continuity.

4. **Other Benefits:** Apart from the above benefits, the following benefits shall also accrue to the organisation where an interim audit is conducted-

1. It constitutes a supportive audit leading the final audit opinion on the financial statements by the statutory auditor.
2. It aids in compliance verification.
3. It aids in substantive verification.

Disadvantages of Interim Audit

Interim audit is also not free from defects. It suffers from the following drawbacks:

1. Figures and accounts audited during interim audit may be altered.
2. It involves periodical finalisation of certain accounting statements, thus increasing the workload of accounts staff.

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Difference between Interim Audit and Continuous Audit

The points of difference between interim audit and continuous audit are given in Table 2.3.

S.No.	BASES	INTERIM AUDIT	CONTINUOUS AUDIT
1.	Period Covered By the Audit	In interim audit, accounting records up to a certain date only are checked.	In the process of continuous audit the accounting records of a whole financial year is examined.
2.	Object of the Audit	The object of the interim audit is to ascertain and check the profit or loss for a given period.	The object of continuous audit is to audit the accounts of the whole year under audit.
3.	Preparation of Trial Balance	In interim audit, the trial balance must be prepared and checked at the time of such audit.	In continuous audit, the trail balance is prepared only after the completion of the accounting year under audit.
4.	Verification of Assets and Liabilities	In interim audit, the verification of assets and liabilities is undertaken at the time of such audit.	In continuous audit, the verification of assets and liabilities is undertaken at the close of financial year.
5.	Scope of the Audit	In interim audit, a detailed and extensive checking of books of accounts is not done.	In continuous audit, detailed and extensive checking of books of accounts is done.
6.	Period of Report Submission	In case of interim audit, the auditor's report is submitted at the time of audit.	In case of continuous audit, the auditor's report is submitted at the end or after the close of financial year.

TABLE. 2.3 - DIFFERENCE BETWEEN INTERIM AUDIT AND CONTINUOUS AUDIT

4. Balance Sheet Audit

The term **"Balance sheet Audit"** is an American contribution. It is more popular in U.S.A. It is rarely used in India and other countries.

Balance Sheet Audit is described as **"Practical Audit"**. It is in the nature of examination of financial statement. It is treated as a brief term of audit. The Balance Sheet Audit is of recent origin and it is expected that it will be more extensively used in future.

In Balance Sheet Audit the auditor verifies the Balance Sheet items such as capital, liabilities, reserves and provisions, assets and other items given in the Balance Sheet. The auditor checks only those documents, which are related to the items given in the Balance Sheet. This type of audit is not aimed at checking Profit and Loss Account and other similar transactions.

Under this audit a backward process is followed to audit the Balance Sheet. First the item is located in Balance Sheet, and then it is located in the original records for the purpose of verification.

This audit is based on the assumption that there exists a reliable system of internal control. It presumes that auditor is highly skilled and experienced.

Although, Balance Sheet Audit concentrates on the items of Balance Sheet, it does not exclude audit of other business operations. As the balance of Profit and Loss Account itself is part of the

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Balance Sheet, it will invariably include the examination of the items recorded in the Profit and Loss Account. It is similar to an annual audit. In India, no distinction is made between Balance Sheet Audit and annual audit.

Suitability of Balance Sheet Audit

The Balance Sheet Audit is suitable to the firms-

1. Where there is a good and efficient system of internal control and internal check.
2. Where big concerns having good mechanised accounts system.
3. Where qualified and efficient accountants operate the accounting system.
4. Which are of small and medium sized ones.

5. Special Audit

A special audit is a type of audit conducted by the Central Government for some special objectives. Under section 233A of the Companies Act, 1956 the Central Government is empowered to appoint a special auditor in the case of companies under certain circumstances. The circumstances are-

1. The management of the company is not in proper form and may cause serious damage to trade and industry and the shareholders of the company.
2. When the financial position of the company is constantly deteriorating.
3. When the company is not being managed according to sound business principles.

The Central Government may appoint special auditor. The person who conducts the special audit is called special auditor. The special auditor must report to the Central Government. The remuneration of the special auditor is decided by the Central Government and is paid by the concerned company.

6. Cost Audit

Cost audit as a discipline and a statutory provision came into being in our country in 1965. This was introduced by an amendment to the Companies Act, 1965, which empowered the Central Government to direct any company to maintain proper cost records in the prescribed manner. In exercise of the power conferred upon the government, the Central Government has prescribed separate sets of rules for different industries. In 1968, the Companies Act was again amended empowering the government to order for a cost audit. The cost audit is conducted in addition to the financial audit. However, unlike financial audit, cost audit is to be conducted only if the Central Government makes an order for a particular year and for a specified company. Cost audit as the name suggests is an audit of cost records. The Institute of Cost and Works Accountants of India, defined cost audit as an audit of efficiency, of minute details of expenditures while the work is in progress and not a post mortem examination. It is mainly preventive, a guide for management's policy and decision in addition to being a barometer of performance.

Scope of Cost Audit

The cost audit extents to the verification and checking of the following areas:

1. **Services:** Utilisation of power, fuel, water, steam and electricity and that of material, labour and other costs like overheads allocated to the service department.

2. **Wages and Salaries:** Maintenance of employment and attendance records, overtime and idle time records, allocation of wages and salaries among various departments and those connected with the capital work.

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3. **Overhead:** The overheads like production, administration, selling and distribution should be allocated on a reasonable basis. The cost auditor ensures a fair and equitable distribution of overheads between various departments, reconciliation of the cost records with that of financial records, overhead recovery rates, and basis for allocation of cost between fixed and variable.

4. **Depreciation:** Maintenance of fixed assets registers with quantitative details, situation, method of calculating depreciation, allocation of depreciation in respect of the common assets.

5. **Production:** Daily production reports, summaries from daily to monthly, monthly to yearly and comparison with past records and budgeted targets including abnormal losses, work in-progress, etc.

6. **Work-in-Progress:** Maintenance of records viz., job cards, work order, cost ledger, etc. and their valuation method.

7. **Stock Verification:** Inventory records for stock- both finished and unfinished products, spares and stores, tools, machinery spares, etc, their values, issue procedure and balances.

8. **Utilisation of Capacity:** Plant utilisation and capacity utilisation are not considered in detail in financial audit. Under this category the cost auditor's examination covers the following aspects- total available hours, standards hours, planned hours, and actual hours worked. Practical capacity, standard capacity, expected capacity, and actual capacity utilized.

Besides, the cost auditor's examination covers various other aspects viz., royalty payments, company policies with regard to inventory management, productivity, internal control, internal audit, cost reduction, export performance, bottlenecks in the production process, inter-company transactions, etc. Hence, from the practical utility point of view, the scope of cost audit is much wider than the financial audit.

Objectives of Cost Audit

We shall discuss the objectives of cost audit under the two heads, viz., 1. General objectives, and 2. Social objectives.

General objectives of Cost Audit

The general objectives of cost audit can be enlisted as follows:

1. Detection of errors and frauds.
2. Verification of the adequacy of the books of accounts and the accounting system.
3. Correct valuation of work-in-progress.
4. Verification of the total cost of each product, process, operation, and job.
5. Verification of inter-company transactions and the reasonableness of the price charged for inter-company transfers.
6. Verification of statistical statements and other records to be submitted to the Directorate General of Technical Development, and Central Excise so as to see that these are reconciled.
7. Providing assistance to the management by bringing out the deficiencies to its notice and thereby avoid inefficient use of resources like capital, labour, raw material, etc.
8. Advising the management for the adoption of alternative courses of action by preparing the cost plans.

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Social Objectives of Cost Audit

The cost audit has certain well-defined social objectives, which are as follows:

1. Protection of the interest of the investors and other shareholders.
2. Efficient utilisation of resources.
3. Ensuring quality of the functioning of the corporate management.
4. Overall improvement in the socio-economic structure.

7. Branch Audit

Some companies have branches in various towns and cities. Commercial banks open branches throughout the country. Large scale concerns like T.V.S. open branches at various places. Besides, certain big private concerns and partnership concerns also try to promote their sales through opening up of their branches at various locations. Branches also carry on commercial transactions on a large scale on par with Head Office. The profit and loss of these branches also should be incorporated into the Profit and Loss Account of the Head Office.

Hence, the accounts of branch offices should also be properly audited. Such an audit is called branch office audit. As branch audit is also a part of annual audit. The Companies Act specifically gives the provisions as to branch audit. We shall discuss about these provisions later in a subsequent chapter.

8. Social Audit

Social audit is now receiving worldwide acclaim and is declared all over the world. It is a devise to measure the benefits (contributions) made by an enterprise to the society.

In the words of **Bauer**, "*The concept of social audit is a vision that at some future time corporations will assess their social performance in as systematic a manner as they now assess their financial performance*".

Social audit aims at the protection of the interests of consumers, employees, and all those who are affected by the decisions of the company i.e., society at large. The need for this audit arises due to the tendency on the part of the business to use its power indifferently, irresponsibly or in an anti-social way. Thus, social audit is considered as a sophisticated and scientific technique of testing the truth of the social performance of a company with reference to its means and motives by an independent authority with a view to detect and prevent abuse of power.

Social audit emanates from the basic democratic principle that "*Those entrusted with authority must account for the use of the authority so that every one knows as to what is going on in the business and other centers of authority*".

Social audit assesses the contribution of an enterprise to the society. It is concerned primarily with the relations of the enterprise with the people, the environment, and the products. It refers to the obligations of the auditor to justify their performance in terms of the objectives and the values of the society. It includes propriety audit.

The social auditor tries to ascertain whether the acts of the business are in public interest, they meet the generally accepted standards of conduct, if the decisions taken have been prudent and have been implemented with wisdom. He tries to establish the relation of the business with the society, environment, and its products. He determines whether the business meets the tests of public interest and commonly accepted customs and standards of conduct. He has to examine the regularity, prudence, and the impact of the various actions and decisions of the authority.

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The scope of social audit is very vast and includes following areas of social interest:

1. Pollution control.
2. Reduction of environmental hazards.
3. Reclamation of new lands.
4. Proper harnessing of natural resources.
5. Energy and raw material conservation.
6. Educating and giving training to employees.
7. Health, safety, and welfare of the workers.
8. Workers participation in management.
9. Improving the quality of products.
10. Reducing the costs of production.
11. Encouraging arts, sports, and community, living advancement in efficiency, productivity, research and development.
12. Maintenance of good employee-employer relations.
13. Policies regarding wages, prices, and profits.
14. Fair trade practices.

In order to achieve some of the objectives of social audit, government has issued Manufacturing and Other Companies (Auditor's Report) Order 1975 (Which is now called The Companies (Auditor's Report) Order, 2003 (CARO, 2003)). The Order 4 of CARO, 2003 requires the auditor to report on recording and physical verification of fixed assets, on revaluation of assets, verification and valuation of items of closing stock, loans from companies under the same management, internal control regarding purchases of assets, reasonableness of the prices of purchases made from companies in which the directors are interested in various capacities, adequacy of provisions for unserviceable or damaged stock, compliance regarding rules for public deposits, recording of the sale of scrap and byproducts, adequacy of the internal audit system, regularity regarding deposits of provident fund, investor education fund, sales-tax, health tax, service tax, customs duly, excise duty, cess, etc.

The Companies (Auditor's Report) Order, 2003 (CARO, 2003) shall apply to every company including a foreign company as defined in section 591 of the Act, except the following:

1. a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949).
2. an insurance company as defined in clause (21) of section 2 of the Act.
3. a company licensed to operate under section 25 of the Act.
4. a private limited company with a paid up capital and reserves not more than rupees fifty lakh and which does not have loan outstanding exceeding rupees twenty-five lakh from any bank or financial institution and does not have a turnover exceeding rupees five crore at any point of time during the financial year.

The auditor of such companies must include the various matters specified in the Order in his report.

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2. Audit Programme

After the work is distributed, the next work of the auditor is to prepare a detailed schedule or programme regarding his work. This is what is called Audit Programme. Audit programme is a written plan containing exact details with regard to the conduct of a particular audit. An audit programme consists of procedures undertaken on the particular work done by an accountant in carrying out an audit. It may be referred to a description, memorandum or an outline of the work to be done, prepared by an auditor for the guidance and control of assistants. An audit programme provides a guide in arranging and distribution of work and in checking against the possibility of the omissions.

Audit programme is necessary for adequate planning and supervision of an engagement under the first standard of fieldwork. An audit programme should be elastic. It should be chalked out in such a way that if there may be any need for revision that may be carried out without any difficulty.

To sum up, the audit programme is the auditor's plan of action, indicating the work to be accomplished, the audit tests and procedures to be followed in accomplishing it, the persons responsible for the accomplishment of the work and the duration or period within which they have to do it. Various authorities and professional bodies have beautifully defined the term. We shall reproduce some of the notable definitions for the term.

Definition of the AICPA: "*A reasonably detailed listing of audit procedures that the auditor believes as necessary to accomplish the objectives of the examination*".

This definition makes it clear that the audit programme should be flexible enough to accommodate any modification if found necessary when the actual audit work progressed.

According to **Prof. Meigs,** "*An audit programme is a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item and the financial statements and giving the estimated time required*".

Thus, audit programme is the most important control mechanism in an audit. It is a tool for planning, directing, and controlling the audit work. The programme is essential for all types of audit- be it external or internal or whatever type it may be.

The following points should be noted in this context.

1. The Chief Auditor prepares the audit programme.
2. It should specify the techniques to be adopted for the conduct of the audit, and the procedures to be followed.
3. It also specifies the time limit for each audit work i.e., the period within which each phase of the audit work should be completed.
4. The work performed by each audit assistant should be clearly specified in the programme. This will enable the auditor to fix responsibility of each assignment.
5. It contains some limits on certain matters and also lay down specific guidelines.

An audit programme should be designed keeping in mind the following three important things:

1. How much work is to be done?
2. Who is going to do a particular portion of the work?
3. What is the duration of time by which the work is to be completed?

The specimen audit programme is given in Table 3.1.

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SPECIMEN AUDIT PROGRAMME
PRASANNA AND COMPANY LTD., CHENNAI - 600 005.

Year 20– Month	Cash Book Balanced	Bank Balanced Checked	Petty Cash Book Checked	Cash Book Posting (Debit Side)	Cash Book Posting (Credit Side)	Bought Ledger Vouchers	Bought Ledger Cash Postings	Sales Books Additions & Postings	Returns Book Postings	Journal Examined	Stock Sheet Checked	Bought Ledger Balance Checked	Sales Ledger Balance Checked	Trial Balance Checked	General Ledger Checked	Profit & Loss Account Checked	Balance Sheet Checked	Remarks
January																		
February																		
March																		
April																		
May																		
June																		
July																		
August																		
September																		
October																		
November																		
December																		

FIG 3.1 – SPECIMEN AUDIT PROGRAMME

Purposes of Audit Programme

A well drafted audit programme serves certain important purposes. They are as follows:

1. The audit programme is a blue print for action. Therefore, the auditor gains some insight into the whole audit work even before the work actually commences.
2. It provides guidance to new entrants and less experienced staff members for conducting their work properly.
3. It also constitutes evidence in future of the work performed.
4. Since work allocation is clearly specified, fixing of responsibility is made easier.
5. The audit staff members are made aware of the time schedule within which each work should be completed.

Objectives of Audit Programme

For all practical purposes, the terms objectives and purposes convey the same meaning. However, there is a thin line of distinction. Hence we are enlisting the objectives separately. The principal objectives of an audit programme are:

1. To ensure that no part of the routine checking and verification has been omitted.
2. To provide the assistants with clear instructions as to what and how much work they have to do and also fix the extent of checking so that no time is lost over routine matters or matters of less importance.
3. To allocate the whole work among different audit assistants and to get the work done within the time span.
4. To enable the chief auditor to exercise proper control over the audit job of the firm by giving full knowledge about the progress of various audits.
5. To fix the responsibility for each job and to identify the assistants responsible for each section of the work.
6. To serve as a guide in future for planning the audit work.
7. To complete the work in time.

Types of Audit Programme

The audit programmes can be divided into two categories, viz.,

1. General Audit Programme.
2. Special or Specific Audit Programme.

(1) General Audit Programme

General audit programme, as the name suggests, contains general instructions. Some instructions are common to all audits. The areas covered by such audit programmes are-

1. Related section of the questionnaire on internal control.
2. Ascertainment (Opinion) as to whether the existing system of internal control is sufficient i.e., adequate or not. If it is stated that the systems of internal control are not sufficient the programme should also specify the additional audit procedures necessary in such situations.
3. Follow up of the outlined procedures.
4. Co-ordination plan of sectional audit programmes.
5. Propriety of expenditure of exceptional nature, and
6. Interviews with the officials of the company.

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(2) Special Audit Programme

This programme is prepared for each of the specific functional areas. The contents of the programme depend upon the requirements of the audit and the relevancy of the objectives of the functional areas. This type of programmes should be flexible so that modifications or revision can be made if the circumstances demand so when the audit progresses. It is a tailor made type programme to suit the particular situation. Different programmes for different functional areas such as purchases, stores inventory taking, materials controls, production, work-in-progress, finished goods, cost statements etc. are prepared here.

Whenever, a detailed audit of a specified functional area is found necessary the auditor should prepare a detailed audit programme of a special nature. There are no hard and fast rules for chalking out special audit programmes, since each programme is unique in its nature.

Advantages of Audit Programme

The benefits of a well designed audit programme can be outlined as follows:

1. Assignment of responsibility is made easier since each job or portion of a job is entrusted to specific audit staff.
2. The audit staff can understand the intricacies of the audit area and this will enable them to conduct the audit successfully.
3. The extent of audit work can be estimated in advance. Hence manpower planning also becomes easier.
4. Allocation of work becomes easier. Senior audit staff can be assigned with critical audit work. Works, which need not call for much experience or professional skills, can be assigned to the junior staff.
5. The audit approach, revision plan for analytical review and co-ordination are facilitated
6. The audit staff can understand the audit objectives of each audit area precisely.
7. The audit staff gets a complete picture of the whole work and the nature of evidences to be collected by them.
8. The audit evidences are clarified and so the collection of relevant evidences is made easier
9. Programme-wise time table can be prepared keeping in view the company's own time table and the total time available for the completion of the audit work in all respects.
10. It serves as a complete guide and as a means to control the whole work and its proper execution.
11. It is considered as reliable evidence in future if any dispute arises about the work of the auditor and he is alleged for negligence.

Disadvantages of Audit Programme

There are however, certain disadvantages of an audit programme, which should be taken care of

1. The auditor's task becomes mechanical and as a result initiative and efficiency are adversely affected.
2. There is always a tendency to speed up the work so as to complete it within the required time schedule.
3. A rigid programme cannot be laid down for different types of business because each business has got its own problems.
4. Audit programme is not much useful in the case of a small audit where the books to be audited are very few.

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5. The audit programme may not be completed because certain items may be left from being checked.
6. The periods and the records, which are required to be tested, may not be varied systematically.
7. Even a detailed audit programme cannot consider each and every minute work involved during the course of audit of a business.
8. Inefficient and careless auditors may some time try to conceal their weaknesses and defects on the basis of the audit programme.
9. The audit staff tends to go ahead with the work as per the audit programme. Therefore, there is no scope for adopting new techniques or additional procedures, which are necessary according to the circumstances, which arise during the course of audit.

Precautionary Measures to Overcome the Limitations of Audit Programme

1. The audit programme should be altered as per the internal control system to be reviewed from time to time and from firm to firm.
2. The auditor should also revise it when his client has adopted a new line of action.
3. The assistants should be consulted while preparing the audit programme.
4. A rigid and stereotyped programme should be avoided.
5. Audit assistants while they actually using the audit programme should really feel that they have actually some discretion in practice.

Hence, to guard against the disadvantages, it is usually suggested that an audit programme should be divided into two parts, viz.,

(i) Work common to all types of audit, and
(ii) Work relating to a particular audit.

This will, therefore, leave some scope for modification to be made in the audit programme whenever necessary.

AUDIT NOTE BOOK

During the course of audit the audit clerk experiences several difficulties. He cannot remember everything at all time. So he maintains a book with him in which he makes note of important points and queries, which he has to refer to the client's staff or clarify with the chief auditor. Such a book is called Audit Note Book. It is also used for recording important points to be included in the Auditor's report. It is a complete record of doubts and their clarification. It helps the auditor in his subsequent audits. It is also used as a guide to the other audit clerks.

To sum up audit note book is nothing but a dairy, maintained by the audit staff for the purpose of recording certain points which require further clarification, explanation and investigation. This book generally includes the errors found out during the course of audit, difficulties observed and doubtful queries of various accounting records, etc. This note book usually forms a part of the permanent audit file.

Audit note book is also called as a remembrance book. It contains all matters that come to the notice of the auditor in the course of audit. It also plays an important part in defending the auditors if any legal action is brought against them. Audit note book can be used as authentic evidence in support of the work done by them.

Audit note book may be in the form of a bound book or of a permanent file of the audit office. It may also be in the form of loose sheets where the auditor files these sheets subsequently according to the sequence of dates for the future reference.

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E.L. Kohler formulated a detailed definition for the term. According to him, "*Audit note book is a record, used chiefly in recurring audits, containing data of work done and comments outside the regular subject matter of working papers. It generally contains such items as the audit programme, notations showing how sections of the audit are carried out during successive examinations, information needed for the auditor's office and for staff administration, personnel assignment, time requirements and notations for use in succeeding examination*".

Contents of Audit Note Book

An audit notebook generally consists of the following information:

1. The nature of the business and summary of important documents relating to the constitution of the business such as Memorandum of Association, Articles of Association or Partnership Deed, etc.
2. A list of the books of accounts maintained.
3. Particulars as to the system of accounts followed and the system of internal check in force.
4. Names of principal officers, their duties and responsibilities.
5. Progress of audit work together with the dates on which the work was undertaken and completed.
6. Extracts from correspondence with different authorities.
7. Audit programme.
8. Allocation of work among different audit staff.
9. All queries which have not been clarified so far.
10. Lists of missing receipts, vouchers, bills, etc.
11. Any special point arising during the course of audit to which the attention of the auditor must be drawn.
12. Particulars of cash balances, investments, fixed deposits, and the reconciliation statements of principal bank accounts.
13. Extracts of the minutes and contracts affecting the accounts.
14. Record of audit work done with dates of commencement and of completion.
15. Particulars regarding the financial policies followed by the business.
16. All mistakes and errors discovered.
17. Points to be incorporated in the audit report.
18. Points, which need further explanations and clarifications.
19. All important matters for future reference at subsequent audits.
20. Information of permanent nature relating to the business and notes of all important technical transactions.

These matters are very useful in preparing the audit programmes for subsequent audits.

Importance of Audit Note Book

1. Audit note book shall be taken as reliable evidence even by the Court of law in case of dispute or if the auditor is charged with negligence.
2. It is useful for drawing the audit programmes.

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Advantages of Audit Note Book

Some the advantages of audit note book are given below:

1. Audit note book enables the auditor to record important points, which arise during the course of his audit; otherwise he might forget these points.
2. An auditor can produce this book as a documentary evidence in a suit filed against him for negligence or misfeasance.
3. It facilitates the preparation of the audit report.
4. If the assistant in charge is changed before the completion of a particular work, it acts as a guide and makes the completion of balance work easier.
5. A credit note book makes the work of audit convenient because all the important details about audit can be recorded in this book and, as such, any change in the staff of the auditor does not disturb or dislocate the work of audit.
6. It can help in making an assessment of the work of audit clerks.
7. It provides a key to evaluate the efficiency of the audit staff.

Disadvantages of Audit Note Book

There are, however, certain disadvantages of audit note book. They are as follows:

1. Very often, it creates misunderstanding between the client staff and the audit staff.
2. If it is not properly and carefully prepared it cannot be used as evidence against the auditor for negligence.
3. It develops a faultfinding attitude in the minds of the staff of the audit.
4. Audit staff has to depend too much upon the client's staff for its preparation.

AUDIT WORKING PAPERS

Audit working papers include those papers and documents, which consist of details about accounts, which are under audit. They are the written, private materials, which an auditor prepares for each audit. They describe the accounting information, which he obtained from his client, the method of examination used, his conclusions and the financial statements.

The Institute of Chartered Accountants of India insists on the preparation and keeping of adequate working papers. According to the Institute of Chartered Accounts of India, "*Working papers must include audit programme, queries, explanations given for the queries, schedules of important items like depreciation, inventories, confirmation from third parties, certificates issued by the management, banks, etc.*".

Further, AAS 1- Basic Principles Governing an Audit, states: "*The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles*". Thus, the standard requires an auditor to maintain adequate working paper.

Working papers provide basic evidence of audit conducted in accordance with standard audit practices. They help the auditor in writing the report. The quality of audit work performed by the auditor can be judged by the character and contents of working papers prepared and maintained by the auditor.

Working papers aid in planning and performance of the audit, facilitate supervision and review of the audit work, and provide evidence of the audit work performed.

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Working papers should be properly designed and organised to meet the circumstances of each audit and the auditor's needs in respect thereof. The use of standardised working papers such as checklists, specimen letters, and standard organisation of working papers improves the efficiency with which they are prepared and reviewed. It also facilitates the delegation of work while providing a means to control its quality.

Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit.

According to **Prof. Meigs**, "*The term working papers is a comprehensive one and includes all the evidences gathered by the auditor to show the work he has done, the methods and procedures he has followed and the conclusions he has developed*".

From an analysis of above two definitions, it is clear that the working paper should specify.

1. How the work was planned and supervised?
2. How the internal control system was reviewed and its reliability was assessed?
3. How the evidence was collected and what procedures were adopted to collect the evidence?
4. Whether the testing performed provided sufficient competent evidential matter to enable to form a reasonable basis for an opinion or recommendation?

Thus the working papers constitute a valid evidence of the work done in the current audit.

Importance of Working Papers

Working papers are necessary in all audit assignments. The Institute of Chartered Accountants in its Statement on Auditing Practices mentions, "*It is necessary to prepare and keep adequate working papers*". Similarly, the Institute of Chartered Accountants of England and Wales suggests, "*Working papers are used to an auditor in controlling the current years audit work and planning the audit for next year*". The third Standard of Field Work pronounced by the AICPA requires that "*The auditor should accumulate sufficient competent evidential matter on the financial statements*". From this it clear that there should be sufficient working papers to support independent auditor's opinion.

Apart from the basic objectives, the working papers serve the following objectives and provide several benefits..

1. The working papers serve the auditor both as useful audit tool as well as a permanent record of the audit work performed.
2. They are useful to the auditor to control the current year's audit work.
3. They constitute a reliable guidance for planning the future audit assignments.
4. A review of the audit working papers gives an assurance that the audit work is both accurate and complete.
5. The auditors arrange the data properly in the working papers. Hence, the data become more meaningful and useful for the purpose of the audit.
6. Working papers are necessary to corroborate the work and the findings of all the audit staff.
7. The chief auditor is assured that the opinion is supported by the findings of their audit staff.
8. The working papers constitute complete and conclusive evidence in future as to the entirety and completeness of the audit work.

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Form and Contents of Working Papers

AAS 3 states working papers should record the auditor's plan, the nature, timing and extent of the audit procedures performed, and the conclusions drawn from the evidence obtained.

The form and content of working papers are affected by such matters as:

(a) nature of the engagement;
(b) form of the auditor's report;
(c) nature and complexity of the client's business;
(d) nature and condition of the client's records and the degree of reliance on internal controls;
(e) need for direction, supervision and review of work performed by assistants in the particular circumstances of the case.

Generally, audit working papers consist of the following details:

1. Schedule of debtors and creditors.
2. Trial Balance.
3. Certificate of officials regarding certain important matters like bad debts, valuation of stock, unpaid expenses, accrued incomes, etc.
4. Statement of depreciation.
5. Correspondence between the auditor and the debtors, creditors, etc. of the client.
6. Investment Schedules.
7. Confirmation by the bank regarding the bank balances of the client.
8. Bank Reconciliation Statement.
9. Important extracts from the minute books such as agreement with vendors, hire purchasers, selling agents, etc.
10. Detail of cash balance checked.
11. Adjustment entries.
12. Contingent liabilities certified by the management.
13. Draft financial accounts.
14. Details of clarifications made during the course of audit.
15. A copy of the auditor's book.
16. Letters of representation.
17. Correspondence from legal advisors
18. Pertinent memoranda relating to the audit.
19. Data relating to the review of internal control.
20. Stock holder equity and the minutes.
21. Test of transactions.

Purpose of Working Papers

Audit working papers serve the following purposes:

1. Working papers represent the volume of work performed by the auditor and his staff. Hence, they enable the easy drafting and preparation of a detailed audit report.
2. The various minute details and aspects of the audit report can be well substantiated based on the findings summarised in the report.

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3. They become a valuable documentary evidence for the auditor on the occasions when he has to defend himself against the charges of negligence, etc. leveled against him.
4. They enable auditor to co-ordinate and organise the work of audit clerks.
5. They enable the auditor to advice his client regarding the improvement of the system of internal check and efficiency of the accounting system.
6. They serve as a guide to the auditor in subsequent examinations and help the auditor to plan for the succeeding year.
7. They serve as a means to give training to the audit clerks to summarise the work done by them.

Essentials of Good Working Papers

The essentials of good working papers are as follows:

1. Working papers should be complete in all respects. They should contain all necessary information so that they may be of maximum use.
2. They should be properly organised and arranged so that one may not experience any difficulty in locating a particular matter.
3. They must contain accurate information so that they will be relied upon.
4. They should contain the facts, which are of self-explanatory.
5. The facts given in working papers should be readily apparent to the reader.
6. The relevant details should always be kept in the working papers. All irrelevant information should be kept out of the space in order to enhance their utility for the purpose for which they are kept.
7. The audit working paper files should be properly preserved and filed. These files should be serially numbered and indexed so that they may be made available whenever they are needed.
8. Paper used for the preparation of working papers should be of better quality and uniform size.
9. Sufficient space should be left after each note so that any decision taken by an auditor may be written in that space.

Preservation of Working Papers

Working papers are to be retained in the safe custody of an auditor. The client's staff or third parties should not have access to working papers. The documents are to be preserved for sufficient length of time in order to satisfy the needs of auditor and professional requirements of record retention. The auditor has to maintain the confidentiality of the affairs of the client.

Ownership of Working Papers

The working papers are the matters documented by the auditor. So they are his property. Although, the client may claim them as a record of his business matters, the auditor cannot part with them as his conclusions are based on them and as they provide evidence of the audit work carried out according to the basic principles.

The legal observation in the case of *Sockockinsky V. Bright Graham & Co.* is that "*The working paper belongs to the auditor not to the client, as the auditor is an independent contractor and not the agent of the client*". Similarly the Court of Appeal in the case of *Chantrey Martin & Co. V. Martin* held that "*The working papers prepared by the auditor are the property of the auditor*".

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Thus, the working papers are the property of the auditor. They are not a part of, nor substitute for, the client's accounting records.

II. PROCEDURE OF AUDIT

1. Special Ticks.
2. Routine Checking.
3. Test Checking.

1. Special Ticks

While auditing the books of accounts of a business, often auditor uses a variety of distinctive ticks or symbols to indicate that a particular work has been done. These are called tick marks. They may be in the form of geometric designs, alphabetic letters, arithmetic designation, numbers, etc. For example, they may be of any of the following:

✓, -, =, ●, S, $, o, *, Ⓞ.

Precautions that are required to be taken while Using Special Ticks

The following are some of the safeguards against improper use of tick marks:

1. The auditor should use special ticks for each class of transactions checked such as- posting, casting, carry forward, bank statement, and vouching. Further the same tick should not be used for the same transaction in all the firms. The system of ticks adopted should not be explained to the client's staff. Different colours should be used to distinguish periods.
2. Ticks should be of small.
3. The kinds of ticks used by the audit staff should not be of the same used by the clerks of the client.
4. Auditor should put ticks in different colours.
5. Auditor may use different colours for different years and for the audit of different firms.
6. He should use special ticks for the figures, which had already been erased so as to ensure that no change has been made after an item has been ticked.
7. Each section of the work should be completed up to a certain points otherwise the chances of mistakes will increase.
8. All important totals, balances, important points, etc. should be noted in the audit note book.
9. Two audit clerks together should do vouching.
10. In case of continuous audits, the work should be performed up to a certain date.

2. Routine Checking

Routine checking refers to a checking of routine records maintained in a business unit. There are some records, which are common to all types of business concerns. Business units irrespective of their size or nature of business maintain these records. Checking of these records is called routine checking. Normally, it involves the following four types of functions:

1. Checking of casts, sub-casts, carry forwards and other calculations in the original books of entries.
2. Checking of postings into the ledgers.
3. Checking of totals and balances of various accounts in the ledger.
4. Checking of transfer of balances from ledger accounts to the Trial Balance.

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1. INTERNAL CONTROL

INTRODUCTION

The dictionary meaning of control is - check, authority, command, regulate, direct, govern, restrain or exercise. In the context of management of a business enterprise, the term control denotes a process by which management achieves the expected performance or its objectives. That is control means all the methods and measures, necessary for planning, operating, and controlling a business for the attainment of organisational objectives. Thus, there is no denial of the facts, as well as be evident from business experience that the absence of control measures or inadequacy of control measures are bound to hamper the continuance of business, the efficient running of the business or even its survival. In the absence of control, organisational efforts cannot be co-ordinated together for the attainment of the objectives of the business. Hence control measures are to be treated as the vital lifeblood of any business functioning.

The organisation of a business enterprise usually consists of various levels of management. Therefore, controls also prevail at all levels. The following are usually the levels of controls prevailing in a business functioning:

1. Management control.
2. Executive control.
3. Management by exception.
4. Internal Control.
5. Internal Check.

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The most important control in a business is management control as it relates to the top management functioning. Executive control is the control exercised by those personnel who are at the helm of executions or putting into action the plans, policies and procedures of the organisation with a view to achieve the cherished goals and objectives of an enterprise. Management by exception is yet another control of the top management. In extraordinary circumstances, the events that occurred are reported to the top management. The management looks into such exceptional events carefully and takes necessary action. Now we shall look into the meaning of internal control.

MEANING AND DEFINITION OF INTERNAL CONTROL

Internal control refers to a type of control aspect, which is applied to business functioning in a detailed manner. Various authorities and professional institutions have defined the term as below:

Definition of the Council of Chartered Accountants of England and Wales: "*By internal control is meant not only internal check and internal audit but the whole system of control, financial or otherwise established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the reliability of its records*".

This definition is a universally accepted definition for the term. It clearly highlights the important aspects of internal control and its purpose.

Definition of the American Institute of the Certified Public Accountants: The AICPA formulated two definitions. According to the original definition adopted in 1936, "*Internal control consists of those measures and methods adopted within the organisation itself to safeguard the cash and assets of the company as well as to check the accuracy of book-keeping*". This definition made the scope of internal control extremely narrow. Hence, the original definition was revised to make it broader in its scope. The revised definition runs as follows:

"*Internal Control comprises the plan of the organisation and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to the prescribed management policies*".

This definition is extremely broader than the definition of the Council of Chartered Accountants of England and Wales. It recognises that a system of internal control extends to functions, which might have not directly related to either accounting or financial departments. The Statement on Audit Procedures of the AICPA further clarifies that the phrases "*Safeguarding of Assets*" and "*Reliability of Financial Records*" were referred to as accounting controls. The phrases "*Promote Operational Efficiency*" and "*Encourage Adherence to Prescribed Managerial Policies*," suggest procedures of a non-accounting nature. Quality control methods in the shop, performance reports for salesmen, statistical studies of plant efficiency, etc. can be cited as examples here. These are usually referred to *as* "*Administrative or Managerial Controls*".

From a careful study of these two definition it appears that the modern concept of internal control comprises of two control systems viz., (1) Accounting control, and (2) Administrative Control. Some authors are of the view that internal control goes beyond these two controls and consist of another control known as Financial Control.

Definition of AAS 6: AAS 6 defines the system of internal control as "*All the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its*

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business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information". This definition is also an elaborate one and resembles more or less the definition of the AICPA. It is clear from the above definition that the scope of internal control, according to the above definition, extends beyond mere accounting controls. Thus, operational controls such as quality control, work standards, budgetary control, periodic reporting, policy appraisals, quantitative controls, etc., are all parts of the internal control system.

In an independent financial audit, the auditor is concerned primarily with those policies and procedures within the accounting and internal control systems, which are relevant to the assertions underlying the financial statements. These comprise primarily controls relating to safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records, and timely preparation of reliable financial information. In an operational audit, on the other hand, the auditor reviews all controls including administrative and managerial controls concerned with the decision-making process. An example of administrative controls is the maintenance of records giving details of customers contacted by the salesmen or the procedure of getting the production manager's approval of the samples of a manufactured product.

1. Accounting Controls

The Statement on the Auditing Procedure (SAP) of the American Institute of Certified Public Accountants defines the term accounting control as follows:

"*Accounting control comprises the plan of the organisation and the procedures and the records that are concerned with the safeguarding of the assets and the reliability of the financial records and consequently are designed to provide reasonable assurance that-*

(i) Transactions are executed in accordance with the management's general or specific authorisation.

(ii) Transactions are recorded as necessary (1) to permit preparation of the financial statements in conformity with the generally accepted accounting principles or any other criteria applicable to such statements, and (2) to maintain accountability for the assets.

(iii) Access to assets is permitted only in accordance with management's authorisation".

Transactions are the basic components of the business operations. Authorisation of transactions refers to the management's decision to exchange, to transfer, or to use the assets for specified purposes under specified conditions.

2. Administrative Controls

The Statement on Auditing Standards (SAS) defines the term as follows:

"*Administrative controls comprise the plan of organisation and procedures and records that are concerned with decision-making process leading to management's authorisation of the transactions. Such authorisation is a management function directly associated with the responsibility for achieving the objectives of the organisation and is the starting point for establishing accounting control or transactions*".

Thus, administrative control is mainly concerned with the operational efficiency and adherence to the managerial policies. These controls are not directly connected with financial records. However, these controls constitute the starting point for establishing accounting controls. In this context the SAS exactly clarifies the situation- "***Both controls are not necessarily mutually exclusive***

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because some procedures and some records comprehended (involved) in accounting control may also be involved in the administrative control".

Distinction Between Accounting and Administrative Controls

Though these controls are not mutually exclusive i.e., one is complementary to the other, the difference between the two are more significant:

1. Accounting controls have a direct bearing on the reliability of the financial statements. On the other hand, administrative controls have only an indirect bearing or impact on the financial records.
2. The accounting controls starts where the administrative control ends.
3 The auditor should examine the impact of all accounting control systems whereas the auditor can confine his examination with a very few administrative controls which have direct bearing on the financial records.

MANAGEMENT AND INTERNAL CONTROL

The responsibility for the establishment and the maintenance of the internal control lies solely with the management. It is also the duty of the management to review the system periodically and make changes, which are necessary due to the changed environment. However, the external auditor who evaluates the system should, assist the management in the design, installation and modification of the system.

INTERNAL CHECK, INTERNAL AUDIT AND INTERNAL CONTROL

There are two other terms **"Internal Check"** and **"Internal Audit"** which should be elaborated in this context. Both internal check and internal audit are important parts of the accounting control. The chart given in Fig. 4.1 makes this point clear.

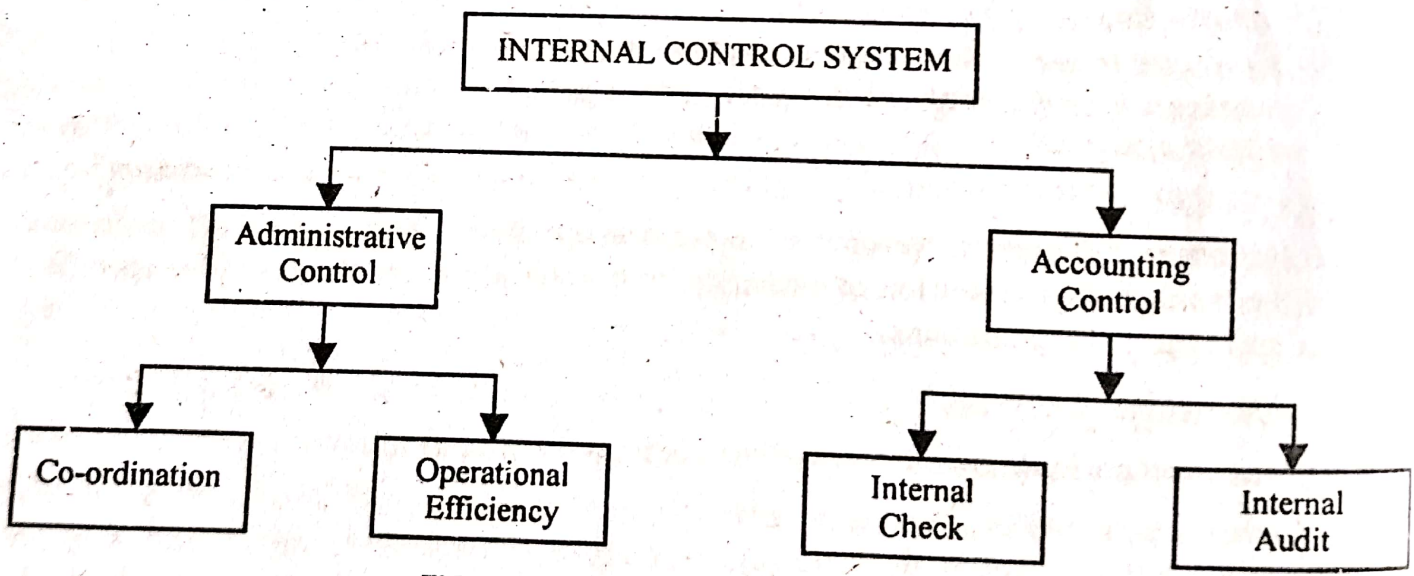


FIG. 4.1 - INTERNAL CONTROL SYSTEM

Internal check can be defined as a system of instituting (Establishing) checks on the day–to-day transactions that operate continuously as a part of the routine system whereby the work of one employee is complementary to the work of another employee. In this process the work of one person is automatically checked by another person. Accordingly the accounting procedures are so designed that no one person is authorised to carry out all the operations involved in any transaction. Thus, internal check is a built-in-system. Internal audit, on the other hand, is an independent

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review of the operations and records, sometimes continuous, undertaken with a specially assigned staff. Many large organisations have a separate internal audit department to carry out a continuous review of the transactions and other happenings in the various functional areas.

It is, thus, clear that internal control is the whole system of controls of which internal check and internal audit are the two important components. Internal check is built in the system itself whereas internal audit is conducted after the transactions have taken place. The whole process is called internal control.

OBJECTIVES OF INTERNAL CONTROL

The objectives of introducing an efficient system of internal control are classified by the authorities into two categories viz., - (1) General Objectives, and (2) Specific Objectives.

1. General Objectives

Internal control system has the following general objectives:

1. Transactions are executed in accordance with the management's general or specific objectives.
2. All the transactions are properly recorded in the correct amount in the appropriate accounts and in the accounting period.
3. Access to the assets is permitted only in accordance with the management's authorisation.

The recorded accountability for the assets is compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any difference.

2. Specific Objectives

Specific internal control procedures designed to achieve the above objects are as follows:

1. Checking the arithmetical accuracy of the records.
2. The maintenance of the reconciliations.
3. The institution of audit routines, control accounts and trial balances.
4. The approval and control of the documents.
5. Comparison with the external sources of information.
6. Comparing the results of cash, security and inventory accounts with accounting records.
7. Limiting direct physical access to the assets and records.
8. Comparison of the results with the budgets.

CHARACTERISTICS OF THE INTERNAL CONTROL

The characteristics of a satisfactory system of internal control are two fold: (1) Personnel Level, and (2) Institutional Level.

I. Personnel Level Characteristics

The personnel level characteristics include the following:

1. The delegation to specific individuals of powers for the approval and institution of checks to see that the transactions are approved by authorised individuals.
2. A division of record keeping such that one record is checked by another record created independently.
3. Proper physical control over assets including dual custody of negotiable and valuable assets.

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4. Separation of the custody of assets from the recording of the same assets and related transactions.
5. Periodic verification of the existence of assets recorded.
6. Employment of the personnel having abilities and training commensurate with their responsibilities.

II. Institutional Level Characteristics

The various institutional level characteristics are as follows:

1. A plan of organisation, which provides separation of functional responsibilities.
2. A system of authorisation and record procedures adequate to provide reasonable accounting control over the assets and liabilities.
3. Sound practices to be followed in the performance of the duties and functions of each of the organisational departments together with managerial supervision and reviews.

BENEFITS OF INTERNAL CONTROL

We have already elaborated the objectives of internal control. These objectives, in a sense, also highlight the benefits of the internal control. The benefits of the internal control system can be summed up as follows:

1. The assets and resources of the business are protected against losses, waste, frauds, errors, inefficiency, carelessness, and other occurrences like theft, accident, fire, etc. Thus, the internal control system ensures protection of assets.
2. The accuracy in the compilation and the presentation of accounting and operating data are promoted.
3. It ensures the reliability of the accounting, cost and financial statements and the accounts.
4. This system enables the company to attain its goals and objectives and ensures the compliance of the procedures established.
5. It facilitates promotion and judging the efficiency of all personnel and operations in all divisions of the company. In other words, the internal control system enables the management to assess the operational efficiency very easily and also helps to improve the performance.

NEED FOR EVALUATION OF THE INTERNAL CONTROL

The auditors all over the world have today recognised the significance of the evaluation of internal control system. The auditors need reasonable assurance that the accounting system is adequate and that all the accounting information, which should be recorded, has in fact recorded. Only an effective system of internal control can contribute such assurance. Hence the auditors before undertaking the audit work should evaluate the adequacy and effectiveness of the internal control system. Besides, there are various other valid reasons, which explain the need for this evaluation.

1. **Growing Complexities of the Business:** Now-a-days business organisations are growing fast in their size as well as in complexities. They should be properly managed. But proper management is not possible if there is no adequate internal control system. Thus, the internal control system is the basis for all the operations and efficiency of a business enterprise. The auditor, as a part of his duty, should also evaluate the control systems.

2. **Impossibility of Detailed Verification:** It is also practically impossible for an auditor to undertake a detailed vouching and post audit of an organisation since the time available is very

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short and his resources are also limited. He can concentrate only in a few areas. Hence he should first evaluate the internal control system and make himself sure whether the system is effective. If the system is found effective, he can concentrate in select areas, which need more detailed verification. However, if the system is found week he is bound to undertake a detailed verification in such weak areas.

3. **Use of Computers:** Another notable development, which makes the evaluation, more essential for an auditor is the increase in the use of computers in maintaining of accounts. Electronic data processing devices have considerably changed the flow of documents and transactions and the auditor may not have intermediary documents and links, which are necessary for a detailed voucher and post audits.

Due to these reasons it is now recognised all over the world by professional bodies regulating the auditing profession that an evaluation of internal control is essential to build up the audit programme. Through a careful review of the internal control system the auditor can ascertain the nature of the internal controls and determine whether such controls are capable of reducing the possibilities of error and defalcation to a minimum. He can also ascertain whether the prescribed controls have been maintained and are operating effectively. **Hermanson**, in this context says, "*The findings developed during the course of his review determine to a large degree the audit procedures to be applied, the amount of detailed checking and contain other features of the audit programme*".

In this, context we shall see some of the declarations made by professional bodies about the need for evaluation of internal control.

American Institute of Certified Public Accountants: The AICPA, in its Statement on Auditing Procedures (SAP) declares:

"*There should be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted*".

This standard is of utmost importance because of the nature of the typical audit examination. **Hermanson** in this connection remarked "*The said procedures used will, not be the same for companies with good internal control as for those with poor internal control*". Hence different procedures should be adopted in different audit situations. That is why the AICPA has made it mandatory for the external auditor to review the system of internal check.

Institute of Chartered Accountants of England: The Statement issued by the Institute of Chartered Accountants of England says, "*Auditors will find it of great advantage to have before them an up-to-date record of the system of internal control*".

This statement, however, does not make the evaluation of the internal control obligatory but only highlights the important benefits of such evaluation.

Institute of Chartered Accountants of India: The Statement on Auditing Practices issued by the Institute of Chartered Accountants of India states "*An auditor is entitled to rely upon the safeguards and the internal controls instituted by the management*". Thus it is implied that the auditor should evaluate the effectiveness of the internal control system and only after satisfying the effectiveness of the system, he can rely upon them.

All these pronouncements are given in our discussion only to highlight the importance and need for evaluation of the internal control system. It clearly shows that this duty is recognised as an auditing standard for the auditors.

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INTERNAL CONTROL AND THE AUDITOR

Basically management is responsible for introduction of sound system of internal control. But it is a matter of concern for the auditor that certain rules and procedures should be adopted by the business in spite of the fact that he has no authority to recommend or prescribe such rules. He can simply guide and help if he is asked to do so. It is clear from the declaration made by the AICPA, which is mentioned in the previous page that the whole purpose of the study of internal control is to decide upon the degree of reliance on the system to enable auditor to assess the extent to which he should apply tests during the course of his audit. The auditor applies various compliance tests in order to determine the adequacy of internal control system. The ICAI has recommended that the auditor should critically review and evaluate the existing internal control system to prepare his audit programme. There is no doubt that if there is a good system of internal control the work of an auditor automatically becomes quite easy. But it does not mean that he can take shelter under the system and shirk to his duties. The entire responsibility lies on him and no one can protect him if he does his work carelessly and negligently.

Review of Internal Control

The auditor's study of the clients system of internal control should be carefully documented. In other words, the auditor while reviewing the internal control system should prepare certain records and these records become an integral part of the working papers and are reviewed in the subsequent audits. Authorities have suggested three kinds of documentation viz.,

1. Narrative Description.
2. Internal Control Questionnaire.
3. Flow Charts.

1) Narrative Description

The narrative description of internal control is a description in the auditor's own words about the client's internal control system. The auditor should also mention the weaknesses identified by him during the process of evaluation. He should also describe the procedures and control system currently in force.

2) Internal Control Questionnaire

It is already stated that the auditor should collect as much information as possible to estimate the effectiveness and efficiency of the internal control system. Internal control questionnaire is a convenient device for collecting the necessary information. The auditor prepares the internal control questionnaire. The questionnaire, as the name suggests, contain a number of questions which the auditor wants to ask in order to verify the existence and efficacy of the internal control system. The questions are predetermined and so the auditor should ensure himself that all the aspects of the internal control system are covered. Separate questionnaires should be prepared for all the areas of the business activities. The questionnaire should list the questions in a systematic and logical way and should be comprehensive in nature. Normally questions are so devised that the answer can be given merely thinking the appropriate word (YES/NO/NOT APPLICABLE).

Some Practical Hints Connected with the Internal Control Questionnaire

At this stage we feel it appropriate to mention some important practical points connected with internal control questionnaire. They are as below:

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1. The questionnaire should be prepared depending on the circumstances inside the organisation. Hence no hard and fast rules are available for drafting the questionnaire. The auditors now-a-days, develop standardised questionnaires. Such questionnaires can be used in almost all the auditing situations. However, some modifications should be made depending on the inside environment.
2. The questions should be drafted in such a fashion to derive one-word answers –Yes or No. But mere Yes or No answers are not sufficient to form a rational judgement about the effectiveness of the control system. Further explanatory replies are necessary to get a clear unde standing of the intricacies involved in the control system. Therefore, enough space should be provided to write the explanatory notes on the questionnaire.
3. The questions should be so devised that an affirmative manner (YES) would indicate a satisfactory degree of internal control.
4. In case where a negative answer is possible, some related questions should also be given so that the questionnaire can be made as informative as possible.
5. The internal auditor should not be satisfied merely with the answers given by the respondents. He should verify whether the procedures indicated by the answers are being carried out in practice. This can be done by observation and/or test check.
6. Space should be provided at the end of each section of the questionnaire for notations as to the adequacy or inadequacy of the system as it relates to the particular section.
7. Each section of the questionnaire should be signed by the accountant or the audit staff making the survey of that particular phase of the internal control. The accountant in charge of the particular activity should sign the questionnaire as a whole. The executive in charge of the work should further review it.
8. Major shortcomings identified during the process of evaluation should be discussed with the executives-in-charge of the functional areas, before reporting the same to the management. This step will ensure a cordial relationship between the internal auditor and other divisional heads. Further, they will also take prompt action to remedy the defects thus noticed.

3. Flow Charts

A flow chart is a graphic representation of the system with the help of symbols, various operations, controls and stages involved in a system are depicted. In the words of **Stephen E. Loab**, "*Flow charts are schematic drawings which show what happens, and when, regarding the systems and the procedures in an organisation*".

Prof. Kamal Gupta defines a flow chart as follows: "*A flow chart provides concise and comprehensive view as to what is taking place in an organisation i.e., what documents are raised, how they are dealt with, what is the flow of goods and cash and what are the various operations etc.*".

Hermanson says, "*In many circumstances, flow chart are easier for an auditor to prepare than a narrative description*". This is because certain complicated systems cannot be exactly described and make others to understand the system as it operates. A flow chart, on the other hand, is comparatively very easy to prepare and show the various phases just as they happen.

The flow charts are generally prepared by the auditor and kept in the working paper file.

Importance of Flow Charts

The importance or merits of flow charts in the evaluation of internal control system can be outlined as follows:

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1. A flow chart enables one to understand even a complicated system very easily. It depicts not only the various phases of a system in a simple manner but also shows their relative importance.
2. For purpose of determining the extent to which documentary and other evidences should be tested, the auditor can use the flow chart as an important tool. The reason is obvious. It can show the whole system of internal control at a glance and the auditor can detect the weaknesses in the system.
3. Flow charts enable the auditor to record the information regarding systems accurately and comprehensively.

Preparation of the Flow Charts

There are many methods for preparing the flow charts. Similarly different people use different symbols. Because of the lack of standardisation, flow charts sometime become difficult to understand. However, some symbols have got universal recognitions. Symbols adopted by the American National Standards Institute (ANSI) and the symbols proposed by International Organisation of Standards (ISO) are recognised all over the world. **Hermanson** suggests a five-step procedure for preparing the flow charts. They are given below:

1. Define exactly what system or procedure is to be charted.
2. Gather the necessary information. **Hermanson** says that there are three ways to gather the information necessary for drawing the flow charts. They are as below:
   (i) By interviewing the persons responsible for the procedure.
   (ii) By tracing the documents through the steps in the procedure.
   (iii) By questioning each person about the documents he has, then compiling the procedure for each document.
3. Determine a tentative organisation for the chart (i.e., whether columns should represent organisational units, functions or persons) and drew a rough sketch of the system or procedure.
4. Draw the flow chart.
5. Trace the hypothetical transaction through the chart (with the client's personnel if possible) to see if any mistakes were made in drawing the chart.

Guidelines for Preparing a Good Flow Chart: Authorities like **Hermanson, Skinner** and **Anderson, Robert H. Strawser** have outlined certain guidelines for preparing the flow charts. The internal auditor should follow the guidelines while preparing the chart. They are given below:

1. Each flow chart should have a heading. The heading of the flow chart should include the following- (i) The name of the company, (ii) The procedure being analysed, (iii) The person originally prepared the chart, (iv) The date of its original preparation, (v) The source of information, (vi) The person approving the chart, and (vii) The date of approval.
2. The flow chart should be divided into two columns separated by double lines. Each column should represent an organisational unit such as Accounting or Sales or a function such as Billing, Payment or a person such as Accountant Manager, etc.,
3. The flow chart may be prepared on a paper with light squared background i.e., a graph paper. The dimension of the flow chart paper depends upon the complexity of the procedure to be shown. However, **Anderson** says that it is convenient to have a flow chart, which is easily manageable- say from 12 to 24 inches length and 9 to 18 inches in breadth.
4. It is preferable to divide the whole system into four or six main phases. This will ensure that the flow chart is not unwidely and can be studied very easily. If the phases of a system cannot be limited to six phases, it is desirable to prepare two or more flow charts.

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5. There are two approaches in the preparation of a flow chart namely, vertical and horizontal. Most auditors prefer horizontal charting. This method is best suited to make an intensive analysis of the movement of the documents and the accounting information between different employees and departments. Further this method enables the auditor to obtain an understanding of how the logic of a system operates and can trace out the weaknesses and inefficiencies in the system.
6. Explanations should be written within the symbols if the space provided is sufficient. These narrations are normally in an abbreviated form. If there is no sufficient space, use a circled capital letter to key to an explanatory note given below. Or an asterisk mark can be placed on the chart. Very long explanations should be avoided. Further, no writing should appear outside the symbol.
7. The origin and final disposition (e.g., discard, permanent files, or transfer outside the company or column) of each document must be shown by the appropriate symbol.
8. Flow charts should not be drawn directly between two documents. If for example two documents are to be compared they should be shown flowing to an activity symbol.
9. Proper spacing between symbols, logical approach and neatness are the key factors to a good flow chart. The person preparing the flow chart should always keep these three key factors in mind.

LIMITATIONS OF INTERNAL CONTROL

The internal control system, if operated effectively can give only a reasonable assurance and not a cent-per-cent assurance to the auditor. In fact no control system is cent-per-cent effective. The internal control system is also subject to certain inherent limitations. They are as follows:

1. Management will prefer to adopt a system only when it is cost effective. This means that the cost of a control procedure should be economic and proportionate to the potential loss due to some fraud or errors. This cost factor poses a serious limitation on the effectiveness of the internal control system.
2. Most controls aim to avoid anticipated types of transactions and not aim at controlling the unusual transactions.
3. Human error due to carelessness, distraction, mistake of judgements, or the misunderstanding of instruction may also hamper the effectiveness of the internal control process.
4. The employees in collusion with other employees or outsiders may also circumvent (prevent) the operation of the control system.
5. There are also chances for a person responsible for checking and exercising control may misuse this responsibility and ignore the control procedures.
6. The procedures themselves may become inadequate due to the changes in the environment and so compliance with the established procedures may become difficult.

PROBLEMS AHEAD IN THE INTERNAL CONTROL APPRAISAL

Internal control evaluation shall become more and more complex in the years to come. The reasons for this expectation are:

1. Business problems are mounting, as the organisation grows larger and larger.
2. Running of the business shall become more complex in the years to come.
3. Government regulations will become more stringent.
4. There is an upward trend in the all round costs. Thus they will increase further in future.
5. Diversification of the business operations.

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6. Consumer needs will become more and more sophisticated. Consumers will demand quality products at cheaper prices.
7. Competition will become more acute than it is at present.

Hence it has become an important task for the management as well as for the internal auditor to ensure the effectiveness of the control measures.

II. INTERNAL CHECK SYSTEM

MEANING & DEFINITION OF INTERNAL CHECK SYSTEM

The terms internal check and internal audit do not mean one and the same thing. De Paula defines the term internal check as follows:

"An internal check means practically a continuing internal audit carried on by the staff itself by means of which the work of each individual is independently checked by other members of the staff".

Under this system the accounts and procedures are not under the absolute and independent control of any one person. On the other hand the work of the employee is complementary to that of another. The essential characteristics of the internal check can be summed up as follows:

1. The work is properly divided in such a way that all the duties are assigned to different employees
2. No single person is allowed to perform the entire work from the beginning to end.
3. The work done by one clerk or employee is automatically checked by other employee This process checks the whole work in different stages and thereby chances for error fraud are minimised altogether.

DISTINCTION BETWEEN INTERNAL CHECK AND INTERNAL AUDIT

As stated already, both internal check and internal audit are the constituent elements of the internal accounting control system. Internal audit, presupposes the existence of internal check system. The internal audit, in fact, aims to locate or pinpoint the weaknesses in the existing system of internal check and tries to suggest suitable remedies to avoid the deficiencies noticed. Hence is clear that internal check is a too narrow concept and is limited purely to routine checking where internal audit is a specialist function. The work is concerned with the evaluation of various control systems of an organisation. One such control systems is internal check. The internal audit reviews all the control systems including internal check, traces out the deficiencies in each system and suggests improvement.

FUNDAMENTAL PRINCIPLES OF INTERNAL CHECK

The following are some important principles, which make the internal check efficient and successful:

General Principles

1. The work of the business should be allocated among various clerks in such a manner that their duties, rights and responsibilities may be clearly and judiciously divided.
2. The work should be so distributed that no single person is allowed to do a job solely himself from the beginning to the end.
3. One person should be entrusted with the similar nature of work to ensure efficiency and specialisation.

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4. It is also necessary that no clerk should be engaged on a particular job for a long time.
5. It must provide for an automatic checking of the work of an assistant by another.
6. The division of work should be economical.
7. No clerk of the business should be relied upon heavily.
8. Self-balancing system should be used.
9. Labour saving devices such as cash register, calculating machines, time recording clocks, etc., should be used.
10. There should be a proper system of filing vouchers, correspondence, etc., in the business.

Specific Principles

1. A responsible person should be made responsible for receiving letters, etc. All important letters, registered envelopes and money orders should be entered in a proper register and then passed on to the clerks concerned.
2. All the cash received should be deposited daily into the bank.
3. Persons dealing with cash, securities, cheques, etc. should be compelled to take annual holidays in unbroken periods.
4. Purchase, receipt and issue of goods should always be done under strict supervision and control and no body should be permitted to take away any goods without proper sanction.
5. Jobs relating to bad debts, allowances, returns, etc. should be performed under strict control.
6. It should be seen that some responsible person is assigned the task of dealing and corresponding with the debtors and creditors of the business.
7. Important work like payment of wages, valuation of stock, sales, etc. should be done under strict supervision and control.

ADVANTAGES OF INTERNAL CHECK

The advantages of internal check can be discussed under three heads as below:

Advantages to the Business

1. Internal check provides a proper and rational distribution of work between the members of the staff of a business. So their duties can be determined precisely.
2. It enables the easy detection and discovery of errors and fraud.
3. The possibilities of the commission of errors and fraud can be minimised.
4. A good system of internal check increases the efficiency of work in a business. This is because the clerks do their jobs carefully and cautiously.
5. Efficient operation of internal check enables the staff to prepare the final accounts with ease and quickness.
6. A moral check is exercised on the clerks of business and this leads towards more efficient and economic operation.

Advantages to the Auditor

7. If there is a good and efficient system of internal check, the auditor may rely upon it and need not make a detailed checking of the accounts.
8. The auditor may apply a few tests here and there very conveniently.

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Advantages to the Owner

9. If there is a good internal check system, the owner may rely upon the genuineness and accuracy of the accounts.
10. The cost of production is reduced.

DISADVANTAGES OF INTERNAL CHECK

The internal check is also not free from defects. The following are the disadvantages of internal check:

1. The clerks of a business are not so serious as they ought to have been.
2. It makes the high officials to feel over-confidence that the work is automatically going on efficiently.
3. Internal check may be quite expensive.
4. If the whole system is not properly organised, it may create chaos and disorder in the working of a business.
5. The work of the auditor cannot be free from irregularities if the system itself is defective.

To provide a safeguard against its disadvantages, it is essential that the system of internal check should be adopted very cautiously and carefully. Nobody can gainsay the fact that the system is of vital significance for the efficient running of a business.

INTERNAL CHECK AND THE AUDITOR

It is true that an efficient system of internal check can make the work of the auditor easy and convenient. Therefore the auditor should examine the system carefully and work with prudence and caution. It is, of course, true that a good system, can be of much help to him. But if, on the contrary, the system is defective and has some weaknesses to arouse his suspicion, he should not presume that everything is all right. He should carry on a detailed checking of the books of accounts. The defects inherent in such a system can point to the directions in which chances of errors and fraud exist. If the auditor does not care for these shortcomings and fail to detect an irregularity, he will be held responsible.

III. INTERNAL AUDIT

DEFINITION OF INTERNAL AUDIT

The definitions formulated by the Institute of Internal Auditors, U.S.A. are given below to know the meaning of the term:

1. *"Internal Audit is a control that is concerned with the examination and appraisal of other controls – in seeing that the assets of a business are properly protected and accounting for, the current transactions are promptly and completely recorded, that faulty, inefficient or fraudulent operations are revealed and that business is adequately protected, against waste, fraud and loss".*

   This definition clarifies the purposes of internal audit. The ultimate purpose of internal audit is protection of the properties or assets of the business, not only from fraud but also from other factors like waste, loss, etc.

2. *"Internal Auditing is an independent appraisal activity within an organisation as a service to the organisation. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls".*

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NATURE OF INTERNAL AUDIT

From a closer review of these two definitions, we can infer the key dimensions, which determine the nature and scope of internal auditing. Particularly the following words highlight the nature of internal audit:

1. **Independent:** The internal auditor should work independently. The word independent implies that the audit work should be free from any sort of restrictions that may have a significant impact on the scope and effectiveness of the review process and on the reporting of the findings and conclusions. Therefore, the internal audit work is detached from regular day-to-day operations of the organisation.

2. **Appraisal:** The word appraisal implies a critical evaluation and assessment of the existing controls and operations of the business enterprise. The internal auditor should appraise them on the basis of appropriate criteria.

3. **Established:** The management should organise an independent internal audit department and duties should be specifically assigned to the department.

4. **Examine and Evaluate:** The terms of examination and evaluation describe the two fold functional roles and responsibilities of the internal auditor. Firstly the internal auditor should make an examination and enquiry for fact finding. Secondly he should make a judgemental evaluation after thorough examination.

5. **Activities of the Organisation:** Internal audit aims at conducting a systematic examination of records, procedures and operations of an organisation. The internal auditor should carefully examine the controls established inside the organisation. In this sense internal audit can be described as a **"Control Over Other Controls"**. Controls are essential for every organisation. In the absence of controls, it would be impossible for any organisation to protect its assets, rely on the records and perform its functions successfully. The internal auditor examines the effectiveness of each control system and traces out the deficiencies in each system.

6. **Service:** Internal audit is a service to the whole organisation. The internal auditor is an employee of the organisation. His services can be availed at any time of emergency. His advices can be obtained on any matter or point significant from the business and strategic point of view. His services can also be effectively utilised by other employees from the top to bottom. Any employee can consult him in solving the day-to-day problems.

7. **To the Organisation:** The internal auditor is concerned with any phase of business activity where he can render any service to the management not only top management but all other managerial as well as operating staff. Therefore, the internal auditor should be an expert in all branches of business. In this respect, the internal auditor is superior to the financial auditor and even the cost auditor. His services are very useful to all the employees throughout the organisation at all times. The terms **"To the Organisation"** also signifies that internal audit is a total concept of service having a broad meaning and connotation.

SCOPE OR FUNCTIONS OF INTERNAL AUDITING

Internal audit involves five major functions or areas of operation. They are as below:

1. **Reliability and Integrity of Information:** The internal auditor should review the reliability and integrity of financial and operating information and examine the effectiveness of the means used to identify, measure, classify, and to report such information.

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2. **Compliance with Polices and Procedures:** The systems and procedure also have considerable impact on the operation of the business enterprise. The internal auditor should gauge the effectiveness and impact of such systems and report thereon.

3. **Safeguarding the Assets:** The internal auditor should review the existing system for safeguarding the assets and if necessary should verify the existence of such assets.

4. **Economical and Efficient Use of Resources:** The internal auditor should also appraise the economy and efficiency with which the resources are employed. Further the internal auditor should identify the conditions, which would prevent the economical use of resources. They are as follows:

1) Under utilisation of capacity.
2) Non-productive work.
3) Procedures, which are not cost, justified.
4) Over staffing or under staffing.

5. **Accomplishment of the Established Objectives and Goals:** The internal auditor should make a review of the operations or programmes of the enterprise and should ascertain whether the results are not inconsistent with the established goals and objectives of the enterprise. He should also ascertain whether the programmes are carried out as per plan.

SERVICES OF THE INTERNAL AUDITOR TO THE MANAGEMENT

His services to the management on various lines are summarised below:

1. **New Business Lines:** The internal auditor due to his detailed knowledge of business functioning can advice the management in acquiring new business, in promoting new products, launching new projects and in undertaking expansion and diversification programmes.

2. **Management by Exception:** Management should generally concentrate only on vital areas, which need their direct attention. Particularly exceptional areas are more important and the management must focus its attention on them specially. The internal auditor can help the management in locating exceptional areas, which need their attention. By this process the managers are relieved from the routine work and concentrate on special areas.

3. **Management Control Process:** The basic foundation of internal audit function is that it is detached from day-to-day regular operations. The internal auditors mainly concentrate on appraising and evaluating the effectiveness of controls established in the organisation. Hence this function has become an integral part of the company's overall control systems.

4. **Availability of Services at all Times:** The internal auditor is an employee of the organisation. His services can be availed at any time for emergency services like investigation, detection of fraud or any other matter, which is significant from the business strategic point of view.

SERVICES TO THE STAFF MEMBERS

The services of the internal auditor can be gainfully utilised as follows:

1. The functional staff is generally occupied with the routine affairs. During the course of work, they might have faced some difficulties and identified some deficiencies in the existing systems and procedures. They can seek the help of the internal auditor to suggest suitable remedies to avoid the present deficiencies.

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2. An independent appraisal of the present systems and procedures and the managerial control enables the management to become aware of the deficiencies in the present situation. Consequently remedial measures can be taken. This factor improves the efficiency of the employees and makes them to achieve peak performance.
3. Various specialist groups such as systems analyst, the corporate planner, and financial analyst can seek the help of the internal auditor.
4. The modern internal audit is concerned with all phases of business activities- whether management, operational or financial functional areas. The internal audit department, therefore, forms an excellent training ground for management development programmes and also for training new entrants.

INTERNAL AUDIT AND EXTERNAL AUDIT

There are some fundamental differences in the status, responsibility, approach and the scope of the operations of the internal auditor and the financial auditor. They are as below:

1. **Qualifications for Appointment:** The external auditor should be a qualified Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 whereas no minimum academic qualification is prescribed for appointing a person as internal auditor. Order 4 of the Companies (Auditor's Report) Order, 2003 (CARO) states that the auditor in his report should state in the case of listed companies and/or other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business.

But there is no academic qualification prescribed for appointment of the internal auditor in the CARO. But the usual practice prevalent is to appoint only qualified Chartered Accountants. However, it is left or the management to determine the qualifications required for the internal auditor.

2. **Method of Appointment and Status:** The shareholders acting in a general meeting appoint the external auditor. His term of office is also fixed. Even if the company fails to appoint an external auditor the Central Government shall appoint an auditor. The external auditor is considered as an agent of the shareholders as a whole. He is not an employee of the company.

Appointment of an internal auditor is not at all compulsory. It is left to the discretion of the management. Even the CARO, 2003 does not envisage a compulsory appointment of an internal auditor. It simply says that if an internal audit system is in force, the external auditor should express his opinion about the adequacy and effectiveness of the internal audit system. Thus, it is clear that appointment of an internal auditor is purely an internal affair. The management appoints him. He is an employee of the company and hence he is subject to the control of the management.

3. **Powers and Duties:** The powers of the external auditor are clearly laid down in the Companies Act. Similarly his duties are also clearly defined in the Act. As such his powers are not delegated by the management but conferred upon him by law. Even the management cannot interfere in his working as an auditor. But the internal auditor is an employee of the company. The management delegates the powers to him. He cannot exceed the powers delegated to him by the management. The management is equally empowered to interfere in his functioning. That is the powers and duties are subject to the limits prescribed by the management

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VOUCHING CASH TRANSACTIONS

CHAPTER 6

Meaning and Definition of Vouching - Features of Vouching - Vouchers - Difference between Routine Checking and Vouching - Objects of Vouching - Importance of Vouching - Examination of Vouchers - Vouching of Cash Transactions.

MEANING AND DEFINITION OF VOUCHING

Vouching is a technical term in auditing. It refers to the inspection by the auditor of documentary evidence supporting and substantiating a transaction. It is considered to be the essence of auditing. Therefore auditor should be very careful while vouching the transactions. Vouching involves not only the substantiating the entry in the books of account with any documentary evidence like assessments, receipts, counterfoils of receipt book or paying-in-book, contracts but also involves seeing that the transactions have been properly authorised, recorded and entered in the books of account. It tests the truth of items appearing in the books of original entry. In order to be a successful auditor, he should be an intelligent person, have common sense, and be tactful in handling his work. He should go to the source of a transaction and go beyond the books of account. He could discover clever frauds by proper vouching only. Hence he should vouch the items with great care and intelligence. He should thoroughly vouch and satisfy himself at each time as to the authenticity and completeness of transactions in the books of accounts.

We shall now see some of the important definitions for the term vouching.

Definition of F.R.M. De Paula: F.R.M. De Paula has defined the term vouching as follows- "*Vouching does not mean merely the inspection of receipts with the cash book, but includes the examination of the transactions of a business together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorised and are correctly recorded in the books*".

Definition of Taylor and Perry: In the words of **Taylor** and **Perry**, "*Vouching may be defined as the examination of the evidence offered in substantiation of the entries in the books including in such examination the proof, so far as possible, that no entries have been omitted from the books*".

Definition of Renold A. Irish: According to **Renold A. Irish**, "*Vouching is a technical term which refers to the inspection of documentary evidence supporting and substantiating a transaction*".

Definition of R.K. Mautz: According to **R.K. Mautz**, "*The examination of documentary evidence in support of entries is often referred to as vouching*".

Thus, from the analysis of the above definitions we can conclude that vouching is a method of examination with the help of documentary evidence in order to ascertain the accuracy of the transaction recorded in the books of accounts.

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FEATURES OF VOUCHING

By analysing the above referred definitions it may be concluded that vouching offers the following features:

1. It involves collection of vouchers and related evidences.
2. It involves evaluation of the collected evidences and vouchers.
3. It refers to the examination of vouchers or evidences and vouchers in a manner that the auditor may satisfy himself with regard to the correctness and authenticity of the records of transactions.
4. It implies finding out whether entries have been properly made in the books of account or not.
5. It involves finding out that there is no omission of any records.
6. It also refers to the checking of the entries with a view to find out transactions not related to the concern have not been recorded the books of account.
7. It forms the basis for final conclusion to be drawn by the auditor.

Thus, in vouching, the auditor verifies the authority and authenticity of transactions as recorded in the financial books.

VOUCHERS

Vouchers are the documentary or other evidences in support of transactions entered in the books of accounts. Particularly transactions, which involve payment or receipt of money, documentary evidence should be prepared. This documentary evidence is called voucher. They are of two types as below:

1. Primary.
2. Collateral.

1. **Primary:** Primary voucher refers to the written evidence in original. Examples of primary voucher are invoice for a purchase bills, contracts, etc.

2. **Collateral:** When the original voucher is not available, copies thereof are produced in support or subsidiary evidence is made available in order to remove suspicions and to satisfy the auditor. Such a voucher is known as collateral voucher.

The following are some of the examples of vouchers.

1. **Cash Receipts:** Vouchers regarding cash receipts include- carbon copies of receipts, contracts, minutes, correspondence, counterfoils, etc.

2. **Cash Payments:** Vouchers in connection with cash payments include- invoices, Bills, Demand Notes, Wage Sheets, Salary Register, Contracts, Correspondence, etc.

3. **Purchase:** Invoices, Goods Inward Book, copies of orders received, correspondence, etc. can be cited as examples of vouchers for purchases.

4. **Sales:** Copies of Invoices, Orders Received, Goods Outward Book, Correspondence, etc. are some of the examples of vouchers regarding sales.

DIFFERENCE BETWEEN ROUTINE CHECKING AND VOUCHING

The points of difference between routine checking and vouching are given in Table 6.1.

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S No.	BASES	ROUTINE CHECKING	VOUCHING
1.	Scope	It is a narrow term and a part of vouching	Vouching is a broader term, which includes routine checking also.
2.	Nature of Work	Routine checking includes checking of castings, postings, carry-forwards, extensions and other calculations in the books of original entry and arithmetical accuracy of the entries is also verified here.	Vouching involves only the checking of entries and no arithmetical accuracy is verified here. Entries are checked with the help of documentary evidence.

TABLE 6.1 - DIFFERENCE BETWEEN ROUTINE CHECKING AND VOUCHING

OBJECTS OF VOUCHING

The main objects of vouching are as follows:

1. Verifying the genuineness of the transactions recorded.
2. Establishing that all transactions relating to the business have been recorded.
3. Determining the authenticity and validity of the documentary evidence.
4. Checking that transactions, which are not connected with the business, are not recorded.
5. Ascertaining that money has been actually paid away by the business in respect of a business transaction only.
6. Ensuring that no fraudulent payments have been made.
7. Ascertaining the correctness of the transactions.

IMPORTANCE OF VOUCHING

Vouching is a sort of preliminary work, which forms an important part of audit work. Vouching is carried on to ensure that the transactions relating to a particular period have been recorded and there is no voucher left unrecorded in the financial books. The auditor after satisfying himself as to the authority and authenticity of the transactions says, "*Books of accounts are correct and Balance Sheet and Profit and Loss account exhibit true and correct state of affairs of the business. If the auditor does vouching with care and caution he can proceed well further in his work. That is why vouching is said to be the backbone of auditing*". This statement seems to be true and correct. With a broken backbone a human being can neither stand nor walk properly. Similarly, with faulty vouching the auditor cannot examine the truth and propriety of the transactions recorded in the books of accounts.

In this context, **Bose** rightly remarked that, "*Vouching is the essence of auditing since it is through vouching that an auditor can satisfy himself about authenticity and completeness of the transactions recorded in the books*".

To quote aptly "*Vouching is not only the backbone or essence of auditing but also is its soul ..... It is the very essence of auditing and the whole success of an audit depends upon the intelligence and thoroughness with which this part of the work is done by the auditor*".

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EXAMINATION OF VOUCHERS

While vouching the transactions, the auditor should first of all examine the various vouchers keeping the following points in mind:

1. **Made in the Name of the Employer:** The auditor should see whether the voucher is made in the name of the employer of the concern.

2. **Printed Form:** He should see whether the voucher is on a printed form.

3. **Serial Number:** He should see whether all vouchers are consecutively numbered and filed in order of the entries in the various books.

4. **Date, Name, Amount, etc.:** The auditor should check date, name of the party to whom the voucher is issued, the name of the party issuing the voucher, and the amounts, etc.

5. **Cancelled by Stamp:** The vouchers, which are inspected by the auditor, should be cancelled by a stamp so that it cannot be produced again.

6. **Related to the Firm:** The auditor should also see that all the vouchers are related with the business or not and see whether the payments made by the concern relate to the business or not. The auditor should pay special attention to those vouchers, which are in the personal name of one of the partners, directors, manager or officers of the company.

7. **Special Mark in case of Detailed Checking:** In case of vouchers, which require detailed checking, the auditor should put special mark on them. He should check such vouchers carefully.

8. **Passing of Vouchers:** The auditor should see that a responsible senior officer of the concern passes every voucher correctly and the rubber stamps are affixed. He should also see whether the responsible official signs them.

9. **Stamped:** If the amount of voucher exceeds Rs.500 it must be stamped. The auditor should note whether the vouchers are stamped so.

10. **Not to take the Help of the Employees:** The auditor should not take the help of the employees of the concern while checking the vouchers.

11. **Type of Account:** The auditor should see whether the payment is made to a capital account or revenue account.

12. **Related to the Year under Audit:** The auditor should see that the vouchers are related to the year for which the auditing is going on.

13. **Amount in Words and Figures:** The auditor should also see that the figures and words of the amount in the vouchers are the same.

14. **Points Regarding Further Verification:** If any transaction requires further verification of any other evidence such as Memorandum of Association, Articles of Association, Prospectus, Partnership Deed, etc. they shall be noted.

15. **Not to Accept Invoice as a Voucher:** The invoice should not be accepted as voucher because there are a lot of chances of double payment i.e., once in the form of credit purchase and second time in the form of cash purchase.

16. **Not to Accept the Mutilated Vouchers as such:** In case if any voucher is mutilated or the amount therein is cut then the auditor should not accept such vouchers as such. They should be made signed by any senior responsible officer of the concern before they are accepted.

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17. **Pad Paper is not Voucher:** Pad papers should not be accepted as vouchers because in such case chances of fraud are more.

18. **Time of Payment:** The vouchers for insurances, rates, and taxes, etc. should be checked by the auditor with reference to the period for which the payment has been made. In case of payments in advance, the auditor should see whether correct adjustments have been made.

VOUCHING OF CASH TRANSACTIONS

In a business concern, cash book is maintained to account for receipts and payments of cash. It is an important financial book for a business concern. Errors and frauds arise mostly in connection with receipts and payments of cash by making misappropriations wherever possible. Hence the auditor should see whether all receipts have been recorded in cash book and no fictitious payment appears on the payment side of cash book.

General Points to be Considered while Vouching Cash Transactions

The auditor should consider the following general points while vouching the cash transactions:

1. **Internal Check System:** Before starting the vouching of cash book, the auditor should enquire about the internal check system in operation. If there is no well organised internal check system, there are lot of chances of misappropriation of cash. He should study carefully the internal check systems regarding cash sales and other receipts.

2. **Examination of Test Checking:** As far as possible, all cash transactions are to be checked elaborately. However, if the auditor is satisfied that there is an efficient internal check system, he can resort to test checking. In such a case, he may check a few items at random and if he finds that they are all in order and free from irregularities, he has reason to assume that the remaining transactions will be correct.

3. **Comparison of Rough Cash Book with the Cash Book:** Usually, cash receipts are entered first in the rough cash book before they are entered in the cash book. The auditor should examine the entries in the rough cash book and main cash book and then compare them to detect whether there is any error or irregularity.

4. **Examine the Method of Depositing Cash Receipts Daily:** The auditor should examine the method adopted for depositing daily cash receipts in bank. The pay in slip should invariably be used for this purpose.

5. **Preparing of Bank Reconciliation Statement:** The auditor should prepare a Bank Reconciliation Statement verifying the bank balance with cash book and pass book and find out the reasons for the difference between the bank balance as per Pass Book and that of in the Cash Book.

6. **Verification of Cash in Hand:** The auditor should verify the cash in hand by actually counting it and see whether it agrees with cash book balance.

7. **Ensuring Proper Control of Receipts Book:** The auditor should see whether receipt books are kept under proper control. While doing so, he should enquire as to whether- all receipts are in printed forms, whether counterfoil receipts are used or a system of carbon copy is used, and all receipt books and all receipts are separately and consecutively numbered.

He should compare the particulars as regards to date, amount, name, etc. with cash book entries. If there are certain entries in cash book for which receipts have been issued, they should be carefully checked. The receipts have to be signed by a responsible officer, and not by the cashier.

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The unused receipt book should be kept in safe custody with some responsible officials. Along with cash receipt, the rule for granting cash discount should be examined. If there is a system under which a receipt accompanies the receipt of cash, such a receipt, usually known as delivery note should be properly signed and returned to the customer.

I. Vouching of the Receipt Side or Debit Side of the Cash Book

The receipt side or the debit side of the cash book contains items such as opening balance, cash sales, receipts from debtors, receipts from bills discounted and bills matured, income from investments, sale of investments, sale of fixed assets, loan received, and miscellaneous receipts, etc. We shall now discuss the vouching of items, which appear in the debit side of the cash book briefly as below:

1. **Opening Balance:** First of all, the opening balance on the debit side of the cash book should be compared with the balance shown in the last audited Balance Sheet to ensure that actual balance has been brought down.

Voucher to be Vouched - Last Audited Balance Sheet.

2. **Cash Sales:** There are greater chances of fraud under this head and so much care should be taken. There is a possibility that salesmen sell goods and do not make entries in the cash book and misappropriate the money. In order to avoid this type or fraud, it is suggested that the following system should be adopted- salesman should not be allowed to receive cash from customers and a person other than the salesmen should be asked to deliver the goods. He should be directed to prepare four copies of the memo of the goods sold, of which three copies are to be handed over to customer; and he has to keep one copy with him. The customer goes to the counter with three copies. The cashier receives the payment and retains one copy with him and the other two copies of the cash memos are returned to the customer with **"Cash Received"** or **"Cash Paid"** seal. The gatekeeper collects and retains the fourth copy with him who hands over the goods to the customers. At the end of the day the salesman, cashier, and the gatekeeper prepare summaries and send them to the General Manager. In vouching the cash sales, cash register should be fully checked with carbon copies of cash memos. Then, the auditor should verify the daily deposits of cash received in the bank. Dates of cash memos and date on which the receipts are recorded in cash book must be same. Where the cash memos are cancelled, all copies including the original copy duly cancelled, should be kept in the book. Where the company has a discount policy, if more discount is allowed in a transaction, a responsible officer must approve it.

Vouchers to be Vouched – Duplicate Cash Memo, Salesman's Abstracts, and Cashier Summaries.

3. **Cash Received from Debtors:** When cash is received from customers, a cash memo is issued; the receiving clerk retains a counterfoil or carbon copy of such cash memo. The counterfoil is the only proper documentary evidence available for vouching. So the cash received from debtors can be vouched with reference to the counterfoils of the receipts issued to them. However, this is not a reliable voucher as frauds are usually committed in the following ways:

1. Entering less amount in the counterfoil than what is actually received from a debtor.
2. Recording less amount on the debit side of the cash book.
3. Issuing a receipt from the unused books. This is possible when they are not kept in safe custody.
4. "Teeming and Lading" or "Lapping".

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Teaming and Lading or Lapping

In the words of **Prof. Meigs**, "*Lapping may be defined as concealment of a shortage by delaying the recording of cash receipts*". It involves misappropriation of cash received from customers. Under this method when cash is received from a customer, say "A" the cashier makes no entry in the cash book, and he misappropriates this money. Later on when cash is received from "B" the amount is recorded on the debit side of the cash book by crediting the account of "A". Again when money is received from "C", the amount is credited to "B"s account and so on. By delaying in recording and replacing of amount the cashier misuses business money. This practice of replacing of money and delaying in recording receipts continues and it will be a never-ending process. It is possible that he may not be able to replace the amount and force to do bigger frauds.

Such practices are common and auditor can check them by examining the rough cash book, counterfoils of the pay in slips and confirmation certificate, and remittance statement received from customers.

Vouchers to be Vouched – Counterfoils, Correspondence, etc.

4. **Receipts from Bills Receivable:** All particulars regarding bills receivable can be obtained from Bills Receivable Book. The receipts from bills receivable are of two types such as-

1) **Receipts from Bills Discounted:** In case of the bills receivable, which have been discounted but have not matured at the date of the Balance Sheet, the cash received by discounting should be properly entered in the cash book. The amount deducted for discount on such bills should be separately debited in the discount account. Contingent liability in respect of such bills should be shown on the Balance Sheet. The auditor should verify cash received for bill discounted with cash book and also verify Bill Receivable Book and pass book. The auditor should ensure that the amount deducted for discount on such bill, is shown separately by debiting in the discount account.

2) **Receipts from Bills Matured:** The auditor should check the cash receipts from bills matured. He should compare it with Bill Receivable Book, cash book, and pass book. Special enquiry should be conducted, as to the bills, which have matured but the amount in respect of which have not been received. Such bills have been dishonored or returned. It is possible that such bills might have been paid but the cashier might have misappropriated these proceeds. In order to discover this kind of fraud the auditor should examine the bill.

Vouchers to be Vouched – Bills Receivable Book, Cash Book, and Pass Book.

5. **Rent Receivables:** The auditor should consider the following points while vouching the rent receivables:

1. If the client has a large number of properties given out on rent, the auditor should ask his client to prepare Rent Register, which maintains account of every tenant.
2. The auditor should examine the Lease Agreements entered into with the tenants in order to note down the rent receivable, the due date and provision for repairs or other allowances, etc.
3. The auditor should examine the counterfoils of rent receipts issued to tenants with the cash book.
4. He should enquire into the arrears of rent, if any. He should confirm it with the tenants with the previous consent of the client.

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5. If rent is collected through the collecting agents, it shall be vouched with statement o summaries prepared by the collecting agents.
6. In case of long outstanding rent, the explanation should be sought for to find out th genuineness of the outstanding.

Vouchers to be Vouched – *Lease Deeds and Agreement, Rent Rolls, Accounts receive from the Agents, Counterfoils, and Correspondence, etc.*

6. Commission Received: While vouching commission received, the auditor should conside the following points:

1. He should examine the agreements for receiving commission as to the rate of commissio
2. He should check the commission account with the accounts of the parties from whom th client receives the commission.
3. He should verify the counterfoils of the receipt with the amount in the cash book.
4. He should do the calculations of commissions as per the terms of agreement to check th accuracy of the amount.

Vouchers to be Vouched – *Agreement, and Counterfoils.*

7. Income from Interest: Interest received on the securities can be vouched from coverin letters received along with the cheques/D.Ds and Schedule of securities. If interest is received o fixed deposits, it can be verified from the bank pass book. If the interest is received on the loa granted to a party, it can be checked from the agreement entered into and counterfoil of receip issued. The auditor should ensure that all interest received and accrued have been accounted for i the books and properly shown in the Balance Sheet.

Vouchers to be Vouched – *Pass book, Agreement, and Counterfoils.*

8. Income from Dividend: While vouching dividends received for the shares held by th client, the auditor should check dividend warrant, counterfoil and covering letter received alon with the cheques. In case the dividend is collected through bank, amount should be verified wit the bank statement. Where the dividend warrant has been received and is not yet collected by th bank it should be shown as cheque yet to be collected.

Vouchers to be Vouched – *Counterfoils, Dividend Warrants, and Pass Book.*

9. Loans: In case, the company obtained any loan, its receipt should be vouched with the agreement entered into with the lender. The auditor should see whether his client is entitled to raise loan. He should examine the rate of interest payable, the terms of repayment, and the security offered, etc. The auditor should see whether security offered is indicated in the Balance Sheet and the interest due but not paid at the Balance Sheet date is adjusted in the accounts.

Vouchers to be Vouched – *Legal Provisions, Agreement, and Value of Security Offered.*

10. Sale of Investments: The amount received due to the sale of investments should be vouched with the broker's sold note. If they have been sold through bank, bank advice should be examined. In case they have been sold "**Cum-dividend**", he should see whether the dividend is received later and that the sale proceeds are apportioned properly between capital and revenue.

Vouchers to be Vouched – *Bank Advice, and Broker's Sold Note.*

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11. **Bad Debts Dividends:** The auditor should vouch the amount received from the debtors who have become bankrupt by examining the counterfoil of the dividend warrants or other related documents. He should ascertain the amount of debt and the rate of dividend from it. He should also see that the accurate amount has been received and entered in the book.

Vouchers to be Vouched – *Counterfoils.*

12. **Subscriptions Received:** Subscriptions received by a club or school, etc. should be checked with the Register of subscribers and the counterfoils of the receipts. Care should be taken to see subscription due but outstanding and the same is brought into account.

Vouchers to be Vouched – *Register of Subscriptions, and Counterfoils.*

13. **Insurance Claim Money:** In case of insurance money received against a claim from an insurance company the auditor should examine the insurance policies carefully to ascertain the terms of claims. He should also check the claims register. He should examine the insurance money received from an insurance company against the claim made by the client with the help of correspondence.

Vouchers to be Vouched – *Accounts, and Correspondence.*

14. **Share Capital:** In case of firms, the Partnership Deed should be examined to find out the amount of capital contributed by each partner. As regards share capital of Joint Stock Companies, it has been dealt in a detailed manner in the Chapter titled "*Company Audit - Audit of Share Capital*".

15. **Sale of Fixed Assets:** In case of sale of fixed assets, the auditor should vouch fixed assets sold out with correspondence, sale contract, Minute of Board of Directors or other evidence available. If sold through auction, the auditor should examine the auctioneer's account.

Vouchers to be Vouched – *Auctioneer's Note or Broker's Sold Note, Sale Deed, and Correspondence.*

16. **Income from Hire Purchase Agreement:** Where money is received on account of instalment relating to goods on hire purchase system, the auditor should examine the hire purchase agreement in detail so as to ascertain the duration of the agreement, the amount of instalments and the total number of instalments payable by the close of the period. The auditor has to keep in mind that the instalment includes interest also. He should note that the whole amount of an instalment is not credited to sales account and it has been properly apportioned between sales and interest.

Vouchers to be Vouched – *Hire Purchase Agreement, and Counterfoils of Receipts.*

17. **Miscellaneous Receipts:** Receipts other than specifically dealt with above, should be vouched with the help of related documents, agreements or correspondence.

Vouchers to be Vouched – *Related Documents, Agreements, or Correspondence.*

Vouching of Payment Side or Credit Side of the Cash Book

After having vouched the receipts side of the cash book and satisfied that there is a good internal check system, he should proceed to vouch the cash payments. However, before vouching the credit side of cash book, he should first evaluate the internal control system for payment of cash. While vouching various payments he should see that-

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1. the payment is made to right person.
2. the payment is actually made for the business itself.
3. the payment relates to the period under audit.
4. the payment is properly sanctioned.
5. the payment is properly recorded in the books of accounts.
6. a proper voucher supports the payment.
7. the payment has been made as per the provisions of the Companies Act.
8. details given in the voucher tally with those of the cash book.

To sum up, vouching of cash payments is made to ensure that the payment is correct, genuine, and properly authorised.

It is true that if an effective system of internal check is in operation, chances of errors and fraud are minimised.

The various cash payments should be vouched as follows:

1. **Opening Balance:** The cash book may have credit balance in the bank column. This balance is to be verified from the last year's audited Balance Sheet.

2. **Cash Purchases:** While vouching cash purchases, the auditor should first see whether the goods paid for, have been actually received. He should examine the entries in the cash book with the help of cash memos or receipted invoices issued by the suppliers and also the Goods Inward Book or Stock Ledger. He should ensure that only the net amount (after trade discount) has been entered in the books. Thus for cash purchases, auditor is expected to examine the genuineness of purchase, receipt of goods, and also the relevant vouchers.

Vouchers to be Vouched – Cash Memos, and Goods Inward Book.

3. **Payment to Creditors:** While vouching payments to creditors for goods purchased, the auditor should first see that purchases are duly authorised and vouch them with cash memos. Money due to them can be compared with the accounts of the creditors and the invoices received from the suppliers of the goods. He should enquire whether creditors submit periodical statements and the same are compared with the creditors account. He may have to refer to minutes, creditors and other evidences before he passes an entry.

Vouchers to be Vouched – Statement of Accounts, and Receipts.

4. **Bills Payable:** Bills payable honoured on the date of maturity and is returned by the payee after receiving the payment should be cancelled after being paid. Bills payable paid can be vouched with bills book. In case of the payment by bank, bank statement or pass book can be examined to verify that the payment of bill is made.

Vouchers to be Vouched – Receipts, Bills Payable Returned, Pass Book, and Bills Payable Book.

5. **Bills Receivable Discounted but Dishonoured:** Sometimes, the bills receivable discounted with the bank is dishonoured by the drawee. In such a case, bank pays the amount of the bill. If the account is maintained with the same bank, bank may debit the account of customer instead of receiving payment. The auditor should verify dishonour of bills discounted from bank's

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advice. The bank also returns the bill. The payment side of the cash book can be checked for the dishonour of such bill with bank's advice and amount of bill plus any charges incurred thereon.

Vouchers to be Vouched – Banks Advice, and Dishonoured Bill.

6. **Wages:** The vouching of payment of wages is an important duty of an auditor. There are many chances of misappropriation of cash under the banner of wages. Before starting the work of vouching wages, the auditor should make a thorough investigation regarding the internal check system, which is in operation in regard to the preparation of wage sheet, maintenance of wage records, and payment of wages. If the system of internal check is not sound, he should bring it to the notice of the client and disown his liability. After satisfying the system of internal check only the auditor should proceed to vouch wages. If there is an effective system in existence it is sufficient for the auditor to satisfy himself that the wage sheets are prepared and checked properly and independently by the office staff. The auditor should see that the amount of wage drawn for each month tallies with the total wage sheet and corresponding payments. He should look into the following to detect frauds and misappropriation of cash:

1. Whether any fictitious names of dummy workers, ghost workers have been included in the wage sheet.
2. Errors and fraud committed in time of work and piece work record.
3. Clerical errors if any, occurred.
4. The name of the workers who have resigned or whose services have been dispensed with may have been included in the wage sheet or the names of ex-employees are to be entered in the wages sheets. This method is known as "**Padding**".
5. Whether the rate of wages are overstated.
6. Hours of work or days of work put in by workers are overstated.

Besides, the above said general points, the auditor should give due importance to the following points also:

1. Few items of deductions such as provident fund, insurance, advance, etc. should be checked as to whether they have been properly adjusted and recorded in the books.
2. Wages for the current month should be compared with the wages of previous months. In case of any increase in wages, he should enquire into the reason for such increase.
3. Total wages sheets should be checked with cash book and ensure that the cashier had withdrawn the exact amount that is required to pay net wages and deposit the amount payable to the provident fund, employees state insurance department, etc. to the relevant accounts.
4. It should be ensured that the unpaid wages are deposited in the bank.
5. It should be checked that wages recorded in cash book have actually been paid and if the amount of wages exceeds Rs.500 revenue stamp of Rupee one has been affixed.
6. The signatures of the workers of two or three periods should be compared to examine their genuineness. Normally, test checking is adopted for this purpose.
7. It should be ensured that all the officers have signed the wage sheet certifying that payment of wages have been correctly made.
8. The system of employment of casual labour should be checked to see whether there is any loophole and if he finds any loophole he should go for a detailed checking.

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In short, wages is vouched with an object of ensuring that the wages as recorded in the wage sheets and cash book, have actually been paid correctly and were properly authorised.

Vouchers to be Vouched – Wage Records, Job Cards, and Wage Sheets, etc.

7. **Salaries:** The auditor should vouch salary register and then compare it with the entries in the cash book. He should see that the total of salaries book for a particular month agrees with cheque drawn for salaries. There may be some variation in salaries, which may be due to sanctioning of annual increments, increase in dearness allowance etc. If it is so the auditor should see whether the increment was actually due, whether there is an increase in dearness allowance, or it is a fictitious entry. The auditor should also refer to appointment letters, contract, service book, etc. in order to see when is the increment due. He should also see that the necessary deduction for income tax, provident fund, insurance and repayment of advance has been made. He should examine that each employee has duly signed the salary register and the same is countersigned by the responsible official. He should examine the Board's Minute Book for the salaries of Secretary, Manager or other senior officials.

Vouchers to be Vouched – Salary Book, Agreements, Appointment Letters, Minutes, and Counterfoils of Cheque.

8. **Traveller's Commissions:** The traveller's commissions are to be verified with travel agent's agreements in order to ascertain the terms and conditions of appointment and the rate of commission. The auditor should examine the sales orders so as to ascertain the amount of sales orders booked by each salesmen and commission payable to them. The payment of commissions should be vouched with the entries in the cash book and receipt issued by them. He should check the calculations also.

Vouchers to be Vouched – Agreements, and Statement of Accounts.

9. **Travelling Expenses to the Staff:** The auditor should study the terms and conditions that are followed for granting travelling allowance. He should check that these expenses are connected to the business alone and have not been paid in advance. He should examine the vouchers submitted for the travelling expenses admitted and should see that a responsible official sanctions the same.

Vouchers to be Vouched – Bills, and Receipts, etc.

10. **Travelling Expenses to Directors:** Directors are paid travelling expenses only when the Articles authorise the same. It is paid either for attending the Board meetings or for other purposes. If the travelling expenses have been paid for attending the Board meeting they can be verified from the provisions for such expenses in the Articles of Association, director's attendance register, and the receipts. All such payments must be supported by the vouchers and the receipts for the payment.

Vouchers to be Vouched – Articles of Association, and Attendance Registers.

11. **Loans:** In case of loans, the auditor should examine the loan agreement entered into with the lender so as to study the terms and conditions of loan. It enables him to know rate of interest, date on which the interest has to be paid, and date of repayment of loan, etc. He should vouch entries in the cash book with receipt issued by the borrower. In case the loan is advanced against security the auditor should verify the title deed, security mortgage deed, etc. If a loan is given to the Director, Managing Director, and any of the officers of a company the auditor should see that the provisions of the Companies Act are duly complied with.

Vouchers to be Vouched – Agreement, and Title Deed, etc.

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12. **Rent Paid:** In case of rend paid the auditor should vouch its payment with the agreement entered with the landlord. The rent voucher should be supported by rent receipt issued by the landlord. The auditor should see that the responsible officer sanctioned the payment of rent.

Vouchers to be Vouched – Agreement, and Rent Receipt.

13. **Rates & Taxes:** Rates and taxes refer to municipal taxes, which are levied for the conduct of the business. The auditor should verify bills and demand notice issued in the name of the client towards these payments. He should also verify the payment made for the bills with the receipt issued by the relevant local authority such as Municipality, Panchayat, and Corporation. He should also verify the period for which the payment is made.

Vouchers to be Vouched – Bills, Demand Notice, and Municipality Receipts.

14. **Advertising:** Advertising is a type of expenditure, which usually involves huge amount. If the amounts spent on advertising are substantial, the auditor should see that adequate controls have been kept on this expenditure. In the case of abnormal expenditure, normally a part of expenditure transferred from one accounting period to another period/periods. Such expenditure is known as deferred revenue expenditure. In case of this type of expenditure only a part is shown in the current year and the remaining amount is spread over a number of years. The auditor should verify the company's advertising policy. He should also verify the bill received from the press or advertising agents.

Vouchers to be Vouched – Companies Advertising Policy, and Bill from the Press or Advertising Agency.

15. **Payment under Hire Purchase and Instalment System:** In case of payment under hire purchase, the agreement and the receipt received from the hire vendor should be examined. The auditor should see that the instalments paid include the interest also, and the interest is charged to revenue accounts. Such payments should be vouched with the periodical statements received from the hire vendor and other relevant vouchers.

Vouchers to be Vouched – Agreement, Receipt, etc.

16. **Interest on Loan:** Business concerns obtain loan from different sources such as bank, financial institutions, etc. Whatever may be the source if loan is obtained, interest thereon has to be paid. The auditor should examine the terms of loan and see that the rate of interest does not differ from the one given in the loan agreement. If interest is payable on debentures, the debentures interest book should be vouched. If the interest is payable through the bank, the pass book and interest register should be examined.

Vouchers to be Vouched – Loan Agreement, Debenture Interest Book, and Pass Book.

17. **Dividend Paid:** The auditor can examine the payment of dividends with the help of dividend warrants returned. If the payment is made through the bank, dividend warrants and pass book may be compared. The amount of unclaimed dividend should tally with the balance given in the pass book on this account.

Vouchers to be Vouched – Dividend Warrants, and Pass Book.

18. **Remuneration to Directors:** Generally, the directors of a company are not entitled to get any monthly salary. However, the directors of a company get fees for attending the Board meetings.

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The Articles of Association of the company or the resolution passed at general meeting of shareholders authorise to claim director's fees. He has to check whether the Articles of Association prescribe the remuneration for him. He should examine the attendance register of the Board of directors or minute book or resolutions passed to that effect in the general meeting. For the payment of commission to the directors, the auditor should check the agreement in order to find out the calculation of profits. He should see that the fees or remunerations paid to directors are shown in the Profit and Loss Account separately. If a director has not forgone his fee, the auditor should refer the minute book so that no misappropriation is done.

Vouchers to be Vouched – *Minute Book, Attendance Register, Articles of Association, and Resolution of Shareholders.*

19. Establishment Expenses: In case of establishment expenses, the auditor should examine the relevant vouchers. He should check that all the expenditures are related to the period under audit.

Vouchers to be Vouched – *Receipts.*

20. Partner's Drawings: In case of partnership firms, the auditor should do the following things to vouch the partners' drawings:

1. Vouching of partners' drawings with memorandum drawing book or partners' drawing book.
2. Seeing whether the partners duly initialed it.
3. Examining the Partnership Deed to ascertain the rules of drawings to be followed by partners.
4. Examining that the rules of drawing have been actually followed by the partners.

Vouchers to be Vouched – *Memorandum Drawing Book, Partners' Drawing Book, and Partnership Deed.*

21. Payment of Taxes: Payment of taxes can be discussed under the following two heads:

1) Payment of Income Tax: The payment of income tax can be checked from the demand notice and receipted challans. The auditor should see that proper entries are made in the accounts keeping in view the payment of advance tax, previous year's tax, and current year's tax. If any penalty is also paid, separate entry shall be made in the concerned account.

Vouchers to be Vouched – *Assessment Order, Demand Notice, and Pass Book.*

2) Payment of Sales Tax: Payment of sales tax can be vouched with reference to the sale tax returns submitted by the dealer and treasury or bank receipt. Such returns are submitted once in a month or quarter. At the time of final assessment for the year, if the amount of tax falls short, he is asked to deposit the difference and if it is in excess, he is allowed a refund.

Vouchers to be Vouched – *Sales tax Return submitted by the Dealer, and Treasury or Bank Receipt.*

22. Insurance: The payment made towards insurance premiums can be vouched with the receipts received from the insurance company and the policy itself. If any policy is renewed, the renewal receipt for the premium should be referred to. The auditor should ask for a Schedule of all the policies if their number is large and check them accordingly.

Vouchers to be Vouched – *Insurance Policy, and Receipts.*

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23. **Deposits:** Companies make certain deposits such as telephone deposits, gas and electricity deposits, and travel warrant deposits. Such deposits should be vouched with the help of relevant receipts. These amounts normally remain in the books uncharged for a number of years. The company should keep a Schedule of all such deposits. However, the cases of deposits should be reviewed to ensure that the circumstances under which they were originally made have charged. Further, direct confirmation can also be obtained from the persons holding these deposits.

Deposit in case of duty is made when exact amount of duty payable cannot be agreed and the purchaser wants to obtain possession of the goods. This type of disputes arises only in certain kinds of machinery and equipment. In such cases, the auditor should see that the invoices for duty have been clearly marked as "**Duty Deposits**" and debited to a debtor account and not written off to revenue account. The auditor should examine the details of the amount on deposit and pay special attention to items, which have been outstanding for a long time.

Vouchers to be Vouched – *Relevant Receipts, Schedule of all deposits, and Direct confirmation.*

24. **Bank Charges:** The auditor should vouch bank charges such as commission, interest on overdraft and loan, etc. by verifying the bank pass book. If necessary, he should check the calculation of interest.

Vouchers to be Vouched – *Bank Pass Book.*

25. **Postage:** In case of postage, the auditor should compare the postage book with the cash book and petty cash book and count the stamps in hand. He should see that postage includes only the postal expenses connected with the business and not with any private account.

Vouchers to be Vouched – *Postage Book, Cash Book, and Petty Cash Book.*

26. **Capital Expenditure:** Capital expenditure refers to the amount of expenditure spent for the purchase of fixed assets. Such expenditures should be carefully recorded in the books of accounts and treated as capital expenditure. We shall now discuss some of the relevant items pertaining to capital expenditure:

1) **Purchase of Investment:** In case of purchase of investment, the auditor should examine the broker's bought note and receipts. He should examine the securities themselves wherever it is possible. Suppose the investment is made in existing shares, share certificate should be examined. He should examine the pass book, if payments have been made through the bank. In case of new issues, letters of allotment, share certificates, etc. may be examined. He should see that the purchase of investments has been properly authorised. If the investments consist of inscribed stocks, the certificate from the bank should be obtained. Investments must be in the name of the company. Where the investments are purchased at cum-interest price, interest included in the purchase price should be debited in the interest account and the balance in investment account. Later on when the interest is received on the investment, it should be credited in the interest account. The auditor should see whether they have been correctly treated in the accounts.

Vouchers to be Vouched – *Broker's Bought Note, Pass Book, and Share Certificates.*

2) **Purchase of Land:** Land may be purchased either on leasehold basis or on freehold basis. In case of leasehold purchases, the auditor should study various terms and conditions of lease agreement. The payment made for leasehold land should be as per the terms of agreement.

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He should vouch the payment with lease agreement and the receipt issued by the lessor. All the expenses incurred for acquiring the leasehold land should also be debited to leasehold land account.

In case of freehold purchase of land, conveyance deed is prepared. The auditor should vouch the payment for freehold land with the receipt issued by the seller, and the amount paid should be compared with sale price as shown in the conveyance deed.

The principles discussed above are also applicable to purchase of building on leasehold basis and freehold basis.

Vouchers to be Vouched – Title Deeds, Receipts, and Contract.

3) Purchase of Building: In case of purchase of buildings, the auditor should examine the following points:

(a) In case any building has been purchased the auditor should vouch it with agreement for sale, title deeds or receipt for the money paid.

(b) In the case building has been constructed under a contract, the auditor should examine the actual contract.

(c) If the buildings have been constructed by engaging labour he should properly examine the expenditure incurred on building material purchased, cartage paid, and wages paid to the workers.

Vouchers to be Vouched – Title Deed, Lease, Auctioneer's Note, Broker's Note, Receipts, Contract, and Certificate of Architect.

4) Plant & Machinery: In case of purchase of plant and machinery, the auditor should vouch the receipts and invoice received from the vendors. The expenditures incurred on the purchase and installation of machinery are to be capitalised by debiting to the concerned asset account. If they are purchased from auction, the auctioneer's account should be examined. If purchased under hire purchase agreement, he should carefully examine the agreement and related vouchers. In case of imported machinery, any import duty and clearing charges should also be debited to the asset account.

Vouchers to be Vouched – Receipts, Invoice, Auctioneer's Account, and Hire Purchase Account.

5) Patents and Copyrights: The acquisition of copyrights and patents should be checked with receipt issued by seller, agent's note, agreement for the purchase of patents and copyrights. All those expenses, which are incidental to the acquisition of patent rights should also be capitalised. In case the patents and copyrights are developed through research and development, all the expenses incurred on research and development should be capitalised as the cost of copyrights and patents.

Vouchers to be Vouched – Agreement, Receipts, and Agent's Account.

27. Petty Cash Book: Business concerns maintain petty cash book to record petty (small) expenses. Generally the petty cash book is maintained under impressed system. Under this system, 1st day of every month the main cashier hands over a definite sum of money say Rs.1,000 to the petty cashier. During the month he makes small expenses against vouchers and the same is recorded in the petty cash book. At the end of the month the petty cashier submits the vouchers to the main cashier. The main cashier after verifying the vouchers reimburses the amount actually spent to petty cashier. This is considered as a good system of internal check. If the auditor finds that the

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internal check system in operation is sound, he should proceed to vouch the petty cash in the following manner:

1. He should see whether all the vouchers are serially numbered and sanctioned by a responsible official.
2. Petty cashier should record the petty cash received from the head cashier on the same day on which it is actually received.
3. Appropriate expense account is debited with the amount spent.
4. All the payments must be verified from the supporting evidence.
5. He should be cautious about the validity of vouchers presented to him.
6. He should consult the postage book for purchases of stamps.
7. He should examine cross-casts and balances of petty cash book.
8. He should physically count balance of petty cash in hand.
9. He may apply test checks in examining the petty cash vouchers at random because they are innumerable small transactions.

28. **Bank Pass Book:** The auditor while vouching the bank pass book should vouch carefully the deposits into or withdrawals from the bank are recorded in the bank column of the cash book. He should vouch the deposits into bank in the form of fixed, current or saving bank deposits with the counterfoils of pay-in-slip book. He should examine that the dates of deposits entered into the pass book and cash book do not differ. He should be very much careful about the deposits made into the bank prior to the date of closing of accounts. He should vouch the withdrawals with the counterfoils of the cheque book. He should examine that the cheques dishonoured have been properly recorded in the cash book. He should examine the bank pass book for bank charges, interests, discounts or other incidental charges. He should be vigilant regarding contra entries in the cash book. He should obtain opening and closing balances from the bank. He should check carefully the copy of the Bank Reconciliation Statement prepared by the client's staff. He should guard against fictitious pass books being presented to him.

REVIEW QUESTIONS

Part - A

1. What is vouching?
2. What are vouchers?
3. State the objectives of vouching.
4. Distinguish between routine checking and vouching.
5. What are the vouchers that are necessary to vouch receipts from debtors?
6. How the opening cash balance is vouched?
7. What are supporting documents used to vouch the purchase of an investment?

Part - B

1. Define vouching. State its objects.
2. What is vouching? Distinguish it from routine checking.
3. Briefly describe the vouching of cash sales.
4. What do you mean by Teeming and Leading?
5. What are the objectives of vouching?

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6. What are the steps taken for vouching the payment of salaries?
7. How is vouching done on acquisition of land and building?
8. How is payment to the creditors vouched?
9. What is traveller's commission and how it is vouched?
10. What is petty cash book? How are its entries vouched?
11. How is loan advanced vouched?

Part - C

1. What is vouching? How would you vouch the cash book?
2. What are the points to which the auditor must pay special attention in vouching payments?
3. "*In vouching payments, the auditor does not merely seek proof that money has been paid away*" Discuss.
4. What are the general considerations to be borne in mind by the auditor while vouching cash transactions?
5. What do you mean by a voucher? What points must be borne in mind while examining the vouchers?
6. "*Vouching is the essence of auditing*". How far do you agree with this statement?
7. "*Vouching is the essence of auditing*". Discuss.
8. "*Vouching is the backbone of auditing*". Discuss.
9. How would you vouch the receipt (debit) side of cash book? Discuss.
10. How would you vouch the payment (credit) side of cash book? Discuss.
11. How would you vouch the following?
    1) Cash Sales.
    2) Income from Investments.
    3) Interest Receivable on Bank Deposits.
    4) Rent Received.
12. How would you vouch the following?
    1) Bills Receivable.
    2) Sale of Fixed Assets.
    3) Interest and Dividends.
    4) Commissions Received.
13. How would you vouch the following?
    1) Travelling Expenses.
    2) Salaries.
    3) Plant and Machinery.
    4) Patents and Copyrights.
    5) Directors' Fees.
14. What sort of vouchers you would require while vouching the payments side of the cash book? What is the auditor's duty regarding missing vouchers?

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VOUCHING OF TRADING TRANSACTIONS

7 CHAPTER

Introduction - Vouching of Purchases Book - Purchase Returns - Goods Received on Sale or Return Basis or Consignment Basis - Forward Purchases - Credit Sales - Sales Returns - Goods Sold on Sale or Return Basis - Goods Sent on Consignment - Journal Proper - Bought Ledger or Creditors' Ledger - Sales Ledger or Debtors Ledger - Total Debtors Account and Creditors Account.

INTRODUCTION

Trading transactions include purchases, sales, purchase returns, sales returns, goods sent on consignment, hire purchase, sale or return, etc. Numerous transactions are carried out in a business concern. Mostly they are carried on credit basis only. In the business, personal ledgers such as Purchase Ledger, and Sales Ledger are maintained to record credit transactions. In Purchase Ledger, all credit purchases are recorded in the names of suppliers, and in Sales Ledger all credit sales are recorded in the names of debtors. In this chapter, we shall discuss the vouching of trading transactions.

1. VOUCHING OF PURCHASES BOOK

As mentioned earlier, Purchases Book is meant for recording transactions relating to credit purchases of goods. The other names of Purchases Ledger are Purchases Day Book, Purchase Journal, Bought Book, Bought Daily Book or Invoice Book.

The main objective of vouching of Purchases Book is to see that all purchase invoices are entered in the Purchases Book, and the goods entered in the Purchases Book are actually received by the business and the client pays money only for those goods that are delivered by the supplier to him.

He must first examine the system of internal check in force in the business regarding credit purchases. He should specially investigate into the procedure followed in placing orders, receiving goods, examining invoices, and maintaining relevant records. If the system of internal check in operation is efficient and effective, he can immediately proceed to vouch the Purchases Book.

Audit Procedure

While vouching credit purchases, the auditor should keep the following things in his mind:

1. The auditor should see that only credit purchases of goods are recorded in Purchases Book.
2. The invoice is prepared in the name of the client.
3. The date mentioned in the invoice relates to the period under audit.
4. The invoice relates to the business, which the concern carries on.

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5. Responsible official who have checked the invoice should initial it.
6. The trade discount received is to be deducted from the purchase invoice and the net amount entered in the purchase invoice should agree with the entry in the Purchases Book.
7. The names of the supplier as entered in the purchase invoice agree with the entry in the Purchases Book.
8. The price mentioned in the purchase invoice should agree with the quotation given by the supplier.
9. The quantity mentioned in the purchase invoice should tally with the quantity recorded in the Purchases Book.
10. The Purchases Book should be verified with the help of purchase invoices, copies of orders placed, goods received note, goods inward book, and copies of challans from supplier.
11. It should be checked that a responsible officer sanctions the purchase of goods and the goods purchased are of similar to those, which the organisation deals.
12. The supplier's bill must be in the name of the business and relate to period under audit.
13. The goods purchased must not be for the personal use of directors, officers, secretaries, etc.
14. Each voucher should be stamped or initialed after the examination is over, so that it could not be produced again.
15. The totaling and casting of Purchases Book should be checked. The auditor should also see that all taxes, octroi, and freight are added to the purchases and trade discounts allowed are deducted.
16. The goods purchased should be actually received by the client.
17. Any purchase not meant for the purpose of business of the client should not be debited to the purchases account.
18. If original invoice has already been recorded care should be taken to see that duplicate invoice is not entered again in the purchases book.
19. Statement from the suppliers may be obtained to verify his purchases records.
20. Sometimes the purchases of the last year may be included in the purchases of first month of the current year or purchases of the last month of the current year may be recorded in the first month of the next year. So the auditor should be more careful while vouching the purchases made in the first month and the last month of the accounting period. Otherwise, the Profit and Loss Account of the current year will not present true and fair position of operating results.

2. PURCHASE RETURNS

Sometimes, goods purchased are returned back to the suppliers for various reasons such as goods are not as per sample, inferior quality of the goods, etc. In such cases, a credit note should be obtained if the price has been paid already whereas if the price is yet to be paid, a note to be sent to the cash department to send less amount to the seller. He should see that the credit note includes the amount which was originally included in the invoice. A separate Returns Book is to be maintained for recording the returns.

There should be proper system of internal control for ensuring that due credit is received in case of purchase returns. Otherwise, credit notes from suppliers might become easy instruments for misappropriation of funds.

The auditor should examine the system of internal check in operation. If he is satisfied with the system of internal check, the auditor should proceed to vouch the Purchases Returns Book in the following manner:

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1. The auditor should check whether a debit note has been sent to the supplier or credit note has been received from the supplier.
2. He should check that the quantity returned as per the return note corresponds with storekeeper's record, Return Outward Register, and Gatekeeper's Outward Register.
3. He should verify the amount shown in credit note.
4. Sometimes the profits of current year may be manipulated by recording current year's purchases returns in the subsequent year. So he should be careful about the recording of purchases returns in the current year.
5. He should vouch the purchases returns of the first month and last month of the accounting year carefully so as to detect any manipulation of amounts.

3. GOODS RECEIVED ON SALE OR RETURN BASIS OR CONSIGNMENT BASIS

Sometimes, goods are received from the suppliers on sale or return basis. Such goods shall not be treated as purchase until the receiver decides to purchase them. Likewise, goods received on consignment basis also shall not be treated as purchase unless the receiver decides to purchase them. Unless and until the receiver agreed that such goods to be treated as purchase, no entry in the books of account should be made for such goods. They should be kept separately in the stores and should not be mixed up with other goods. Closing stock shall not include them. Records for such goods should be maintained in separate Memoranda Book. The auditor should see whether these items are treated so.

4. FORWARD PURCHASES

In certain businesses, forward contracts are made for future purchase of raw materials at a fixed price. Such deals are called "**Forward Purchases**". This kind of transactions is commonly found in cotton textiles, and oil seeds businesses. As these deals involve huge amounts and are subjected to losses, a provision for loss if any expected is to be made. A reference to the apprehended loss must also be made in a footnote to the Balance Sheet. However, if this is not done, the auditor should qualify his report accordingly.

5. CREDIT SALES

Sales Book records only credit sales. The auditor should examine the system of internal check in regard to credit sales, which includes the procedure beginning from receiving orders to the delivery of goods and making payments therefor. If internal check system in operation is sound and effective, the auditor should vouch credit sales in the following manner:

1. He should apply a few test checks.
2. He should compare certain details in the copy of the invoices such as the name, the demand, the amount, etc. with those given in the Sales Book.
3. He should see that the sales are not omitted from being entered in the Sales Book. He can do it by vouching Sales Book with the Orders Received Book and Goods Outward Book.
4. He should see that the sale of an asset is not considered as ordinary sale.
5. If there is a difference in rate of trade discount allowed to two different customers, the reason thereof should be enquired into.
6. In order to confirm the accuracy of balance, the auditor can send Statements of Accounts to the customers.
7. He should check the castings and postings of the Sales Book and also examine the postings to the Ledger Accounts.

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8. He should especially examine the sales relating to the periods in the beginning or at the close of the accounting year under audit to ensure that no manipulation has been made in accounts. He may check such sales with the Goods Outward Book.
9. If goods are supplied on "**Sale or Return**" basis or consignment basis, it should be seen that such goods are not treated as sales till the letters of acceptance have been received.
10. The cancelled invoices should be checked with the duplicate copy of the invoice.

6. SALES RETURNS

Sometimes, the customers on account of their being defective or inferior in quality return goods. In such cases, goods returned should be entered in the Goods Inward Book and Gate Keeper's Returns Inward Book, and Stock Register. A credit note signed by a responsible official should be prepared, and sent to the customers. There are lot of chances of fraud in connection with the sales returns because goods might not have been returned but a credit note be sent to the customer. Therefore, the auditor should pay particular attention to such transactions. He should pay attention to heavy returns at the beginning or at the end of the business period. He should check the postings from the Sales Returns Book to the Sales Returns Accounts and Customer Ledger. The goods, which the customers return are included in the closing stock at cost price or market price whichever is less.

7. GOODS SOLD ON SALE OR RETURN BASIS

Sometimes goods are sold on sale or return basis. Under this type of sale, goods are sold to customers on condition that if the customers do not approve them, they can return them within a stipulated period.

Until the customer approves the goods they cannot be treated as sales. At the closing of the business, it may so happen that some goods rest with customers who have not sent their approval. In such a case these goods cannot be treated as sales. Such goods must be shown as "**Goods with Customers**" and deducted from sales and from the list of debtors on the period under audit. The auditor should see that whether the customers have approved such goods otherwise profit would be inflated.

The unapproved goods by the customer at the time of Balance Sheet should be shown on the assets side of the Balance Sheet as "**Goods with Customers**".

If such transactions are numerous, the auditor should recommend to use "**Goods on Sale or Return Journal**" in order to avoid any confusion between such sales and credit sales. The auditor should vouch journal with any documentary evidence like correspondence, invoice, etc., which may be available.

8. GOODS SENT ON CONSIGNMENT

If goods are sent on consignment, a separate book known as "**Consignments Outward Journal**" should be prepared. This book should be vouched with the copies of agreement, account sale, correspondence, and proforma invoice. Where Goods were sent on consignment at a higher price, proper adjustments should be made at the time of finding the profit or loss. The unsold goods with the consignee should not be treated as sales. They should be included in stock and shown in the balance sheet as "**Goods on Consignment**". Such goods lying with consignee should be valued either at market price or at cost price whichever is lower plus proportional expenses incurred on consignment.

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9. JOURNAL PROPER

All those entries that cannot be recorded in any other book of prime entry are recorded in Journal. In other words, the transactions of extraordinary nature for which there are no special books of original entry are recorded in Journal. The following transactions are usually passed through the Journal:

1. **Opening Entries:** The opening entries are to be checked with reference to the various relevant items on the previous Balance Sheet. If the business has been purchased from the vendor and the relevant opening entries have been passed in the Journal, agreement between the client and the vendor, Articles of Association (if it is a company), and Directors Minutes should be examined to ensure that correct records are maintained and there is no manipulation in the accounts.

2. **Closing Entries:** Closing entries are passed for closing and transferring balance from nominal account to Profit and Loss Account. The auditor should see whether the balances have been correctly arrived at and carried to proper accounts.

3. **Adjustment Entries:** Adjusting entries include items such as provision for bad and doubtful debts, outstanding and prepaid expenses, accrued and unearned income, depreciation and reserves, allocations between capital and revenue, etc. The auditor should check all the available evidences in order to ensure that these entries are accurately and correctly made. He should explore the chances for committing fraud through the Journal and check them thoroughly.

Provision for bad debts should be based on the procedures followed in the past. The auditor should review the procedures followed in the current year and see whether they tally with the past procedures and should see whether they are adequate. Bad debts should be written off only under proper authority and he should see whether it is done so. For outstanding and prepaid expenses and also for accrued and unearned income, the auditor should obtain Schedules from the client and ensure that items have been correctly arrived at. Thus, he should not pass any entry until he is satisfied with regard to its validity and correctness.

To vouch entries for provision for depreciation, he should obtain information with regard to the nature of assets, their estimated effective life and also the bases upon which provision for depreciation has been made. Director's Minutes should also be checked for the authority.

4. **Rectification Entries:** Sometimes, entries are made wrongly. For example, amount to be debited may be credited, or amount to be credited in one person's account may be credited in another person's account, and so on. Such errors can be rectified only by passing rectification entries and not by striking off any entries made in Journal, Cash Book, etc. The auditor should see whether all the rectification entries made are correct and approved by the responsible official.

5. **Entries Relating to Share Capital:** Entries relating to share capital such as issue of shares, allotment and forfeiture of shares, etc. are also passed through the Journal. The auditor should study the Prospectus, Articles of Association, Director's Minutes Book, Applications, Copies of Allotment Letters, Correspondence, etc. in order to check these entries. These items are dealt with in detail in the Chapter on "**Company Audit - Audit of Share Capital**".

BOUGHT LEDGER OR CREDITORS' LEDGER

The auditor should now proceed to vouch the Bought Ledger, which consists of creditors' accounts. He should check the opening balance of different accounts in the Bought Ledger with the previous year's audited Balance Sheet or the Schedule of the creditors duly checked by the

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previous auditor. This ledger should be vouched with the help of the previous year's audited Balance Sheet and all supporting books such as Purchase Book, Goods Inward Book, Cash Book, Allowances Book, Discount Register, and Bank Pass Book. The castings of the accounts in the Bought Ledger should now be checked with the balances as shown in the Schedule of creditors, which has been supplied to him by his client.

If the self balancing system is adopted, the auditor should ask for a Schedule of creditors from the client and total of the Schedule should be tallied with the Creditors' Ledger Adjustment Account in the Ledger Account. The auditor should examine the entire Creditors' Statements and with their help the Purchases Ledger balances should be checked. He should see whether the balances of the Purchases Ledger (whether debit or credit) are shown on the proper side of the Balance Sheet. If provision for reserve for discount on creditors is made, he should ensure that it is not excessive. Such provision for **"Reserve for Discount"** should not be made unless a provision for **"Reserve for Discount"** on debtors has been made. Some Bought Ledger balances may be debit balances on account of goods returned or allowances for defective goods for which payment had already been made. In case such balances are standing for a long time, he should see whether they are bad or doubtful debts. If they are so, he should see that adequate provision is made for reserves.

The debit balance in the Bought Ledger may also be due to the cash having been paid in advance to the seller but the goods might not have been received. This may be due the following reasons- 1. goods are still with the seller, or 2. they are in the course of transit. In both these cases, the auditor should see whether the property in the goods has passed to the buyer or not. If the property is passed an entry **"Goods in Transit"** or **"Goods with the Seller"** should be made whereas it has not been passed to his client, the amount may remain as a debit balance. It is also possible that the **"Advances"** might be a loan to the other party. Hence he should see whether it is a custom to send advance for the purchase of goods.

SALES LEDGER OR DEBTORS LEDGER

After having checked the Bought Ledger, the auditor should now proceed to check the Sales Ledger, which contains the accounts of the debtors. The opening balance of Sales Ledger should be checked with balance given in the previous year's Balance Sheet. Books like Bills Receivable Book, Cash Book, Sales Returns Book or Goods Outward Book, Journal or other subsidiary books should be checked to vouch the accounts in the Sales Ledger. The auditor should call for a Schedule of Debtors' Account and check it carefully. If the books are maintained on the self balancing system, the total of the balance in the Schedule of debtors should tally with the total of the balance shown in the Debtors' Ledger Adjustment Accounts. It should be ensured that the debit or credit balances of the Sales Ledger should be shown on the proper side of the Balance Sheet. The castings of the accounts in the Sales Ledger should now be checked with the Balances as shown in the Schedule of debtors, which has been supplied to him by his client. The manager, secretary, or any other responsible official must certify such a Schedule. There is a possibility of committing fraud by passing fictitious entries in respect of credit notes, cash discounts, allowances in the Sales Ledger. So he should pay special attention to the credit entries in the Sales Ledger and bad debts.

There may be some credit balances in the Sales Ledger, on account of the omission of the record of invoices in respect of goods supplied in which case, necessary adjustments should be made. Further, such a credit balance must not be deducted from the amount of debtors but should be shown on the liabilities side of the Balance Sheet along with sundry creditors.

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In case if credit balance is due to the fact that an advance is made on account of an order placed, it must be shown under a separate head known as **"Advance against Goods on Order"** and should not be included amongst sundry creditors.

TOTAL DEBTORS ACCOUNT AND CREDITORS ACCOUNT

In case of large business houses where the number of transactions is large, total debtor account and total creditors account are prepared to prove the accuracy of the balances of the Bought and Sales Ledgers. These accounts contain all items appearing in the sales and purchase ledgers.

Total accounts are maintained in the General or Impersonal Ledger. Monthly totals of the Purchases Book or Sales Book or Returns Inward or Outward Book are posted in the total accounts. Total monthly receipts from customers and payments to the suppliers are posted in these accounts. Any entry, which affects debtors or creditors, is also posted to the total accounts and simultaneously, it is posted with the individual account either in the Bought Ledger or Sales Ledger. In the total accounts monthly summaries are posted. Thus, the balance in the total account must be equal to the total of the summary of the respective ledgers. This is, however, true that under the self balancing system, the chances of errors are always reduced to the minimum.

REVIEW QUESTIONS

Part - A

1. What are trading transactions?
2. What is journal proper?
3. What are total accounts?
4. What is the purpose of preparing total accounts?
5. How the opening balance of bought ledger is vouched?
6. How bills payable books are vouched?
7. What is goods sent on consignment and how it is vouched?
8. What is debtor's ledger?

Part - B

1. Describe briefly as to how purchases ledger is vouched?
2. How did you vouch goods sent on sale or return system?
3. How an auditor vouches the sales returns?
4. What particular attention the auditor gives while vouching purchase returns journal?
5. How bills payable book is vouched?

Part - C

1. What are trading transactions? Briefly describe the vouching of various trading transactions.
2. How will you vouch the following?
    1. Purchase Returns.
    2. Credit Sales.
    3. Sales Returns.
    4. Sales Ledger.

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VOUCHING OF IMPERSONAL LEDGER

8 CHAPTER

Introduction - Outstanding Assets and Liabilities - Contingent Liabilities - Contingent Assets - Capital and Revenue Expenditure.

INTRODUCTION

Impersonal ledgers are also called General Ledgers or Nominal Ledgers. They are of two types such as Nominal Accounts and Real Accounts. Nominal accounts are related to Trading and Profit & Loss Accounts whereas real accounts record assets. If these accounts are not correct, they will affect the Profit & Loss Account and the Balance Sheet. Therefore, the auditor should vouch the items appearing in the impersonal ledgers thoroughly so that the chances of manipulation by fictitious entries of expenses can be eliminated.

We have already discussed the vouching of the transactions such as purchases, sales, purchases returns, sales returns, wages, etc., which appear in a Trading Account. We shall now proceed to discuss the transactions in the Impersonal Ledger, which relate to Profit and Loss Account. These transactions will be recorded either from the Cash Book or the Journal or the totals of the subsidiary books of prime entry. The Impersonal Ledger, therefore, will be vouched as follows:

1. The postings of cash transactions to the Impersonal Ledger should be carefully checked.
2. The Journal should be carefully vouched to ensure that each entry is supported by sufficient evidence.
3. The auditor should carefully check the totals of the various other books of original entry and the postings thereof to the Impersonal Ledger.
4. Sometimes direct entries are passed from one account to another in the Impersonal Ledger. In such a case the auditor should vouch them in the manner in which he examines those items, which pass through the Journal.
5. He should check very carefully the adjustments, which are usually done at the end of the year when the final accounts are prepared. Such adjustments include outstanding assets and liabilities, depreciation, etc. As these adjustments pass through the Journal, their postings to the Impersonal Ledger should be checked. Special attention should be paid to these adjustments because they ultimately affect the position reflected by the final accounts.
6. The total of the subsidiary books should be checked.
7. The balances in the Impersonal Ledger should be checked and verified with the Trial Balance.

OUTSTANDING ASSETS AND LIABILITIES

Knowing the correct profit or loss for a certain period is a must for a business concern, which necessitates the following:

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1. all income and expenditure which relate to that period should be brought into the Profit and Loss Account, and
2. no income and expenditure, which do not pertain to that period, should be brought to the Profit and Loss Account.

In order to arrive at a correct Profit and Loss Account and to prepare a proper Balance Sheet adjusting entries are passed through the journal and a narration is inserted. Some business concerns prepare and maintain an Outstanding Memorandum Book for the purpose. This book helps the auditor to know exactly as to what the outstanding is, and for which adjusting entries have been passed during the year. The book is useful for the auditor for comparing the outstandings of two periods. Such balances are to be shown as debit or credit balances in the Impersonal Ledger and ultimately shown as assets and liabilities in the Balance Sheet of the concern.

We shall now deal with some of the outstanding assets and liabilities in detail and discuss the duties of an auditor in this connection.

Outstanding Assets

Outstanding assets refer to the assets, which remain outstanding at the date of the Balance Sheet. There are certain expenditure the nature of which is that out of the sum spent on that a portion pertains to the next business period. Examples of such expenses are- 1. prepaid expenses, such as insurance prepaid, rent paid in advance, tax paid in advance, etc., 2.accrued incomes such as interest due but not received, dividend due not received, and 3. deferred revenue expenditure.

1) Prepaid Expenses

As already stated, prepaid expenses are those expenses, which actually pertain to the next financial year but have been paid this year. If the whole of the amount is charged to the Profit and Loss Account of the current year, it will be unduly burdened and the profit or loss thus arrived at will not be correct. Hence that part of the expenditure which relates to the next financial year will have to be shown separately and should be deducted from the total expenditure.

Some of the examples are- prepaid insurance; rent paid in advance, rates and taxes paid in advance, and subscriptions paid in advance, etc. Prepaid expenses are shown on the asset side of the Balance sheet. Such prepaid expenses are to be treated as Current Assets.

The auditor should examine the nominal accounts, receipts, and demand notes and ensure that proper adjustments have been made in the books for the unexpired period. If the prepaid expenses are meager, it should be ignored, because it would not affect the account much.

2) Accrued Incomes

There are certain items of income, which ought to have been received at the date of Balance Sheet but have not actually been received. Such incomes are called accrued income. Examples of such incomes are- rent receivable, interest receivable, and dividend receivable. In order to arrive at the current profit or loss, such items of income must be accounted for in the Profit and Loss Account.

The auditor should go through the records very carefully and see that accrued income, which actually relates to the current year, has been brought into account. The auditor should check the adjusting entries passed for this purpose at the date of Balance Sheet and also scrutinise that they appear on the asset side of the Balance Sheet.

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3) Deferred Revenue Expenditure

Deferred revenue expenditure is one, which is incurred so as to have financial benefit for many accounting years. It is a non-recurring expenditure. The entire amount as such should not be charged to the Profit and Loss Account of the year in which it is incurred because it gives financial benefits for many years. The expenditure will have to be carried forward and spread over a number of years. Otherwise, it will bring an undue and extra burden on the current year's Profit and Loss Account.

Outstanding Liabilities

At the close of the year, there may be some outstanding liabilities for expenses, which must bring into accounts to arrive at the correct profits. If any of these items is not included in the Profit and Loss Account of the current year, the profit arrived at will be overstated. Therefore, the auditor should see that all such liabilities are brought into account before the current year's profit is arrived at. If he fails to do so, he may be held liable for the dividends being declared out of capital due to the omission of certain liabilities. But it may not be easy for an auditor to know whether all the liabilities have been brought into accounts or not. In case of regular expenses like rent, the auditor can easily find out such liabilities. Moreover, he can learn about the existence of such outstanding liabilities by experience. The auditor should obtain a certificate from the responsible officer that there are no expenses incurred, which have not been brought into accounts during the current year.

The auditor should scrutinise the nominal accounts like wages, salaries, rent, rates, taxes, interest, discount, etc. in order to verify that all expenses accrued up to the date of the Balance Sheet have been duly accounted for. He should go through the Cash Book payments and the purchases of the first few months of the next year in order to see that expenses of the period under audit paid in subsequent year. If so, he should bring this fact to the notice of his client.

The auditor should compare the total expenditure with the previous year and if there is an appreciable difference, he should enquire into the matter. He should also scrutinize the Purchases Book to see whether there is any suppression of purchases.

The outstanding expenses and outstanding liabilities can be brought under two heads as shown below: 1. Unearned Income, and 2. Unpaid Expenses.

1. Unearned Income

Unearned income refers to income, which might have been received during the current year though a part or the whole of it is not applicable to the current year but will be earned during the following year. Rent received in advance, interest received in advance, etc. can be cited as examples here. Hence an unearned income, which is not applicable to the year under audit, should not be credited to the Profit and Loss Account of the current period it should be shown as a liability in the Balance Sheet.

The auditor should examine the vouchers and ascertain the amount which is to be credited to the Profit and Loss Account of the current year and the amount which is to be carried forward and will be earned during the subsequent period.

2. Unpaid Expenses

Unpaid expenses are those expenses that are incurred during the current year but for which payment has not been made in the year under audit but will be made in the next year. In case of unpaid expenses, Profit and Loss Account should be debited with the amount and credited with the unpaid expenses and should be shown in the liability side of the Balance Sheet.

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The auditor should examine vouchers, receipts, invoices, demand notes, etc., with a view to ascertain whether the expenses ought to have been debited to the current year's Profit and Loss Account and that no payment has been made.

Some of the common items of outstanding liabilities are discussed below:

1. **Wages and Salaries:** Generally the books are closed on the last day of the month. But items such as wages and salaries of current month are paid during the first week of the next month. As far as last month of the year is concerned no payment will be made in the current year and so wages and salaries of the last month will not be debited to the Profit & Loss Account of the current year. Thus the profits revealed by the Profit & Loss Account would be more than what actually it is. Therefore it is proper that such wages and salaries must be brought into account before arriving at the correct profit. In such a case, wages and salaries account should be debited and outstanding liabilities account should be credited for the outstanding wages and salaries. Further, he should see that Profit & Loss Account has been debited with twelve month's wages and salaries.

2. **Rent, Rates, Taxes, Electricity, Water, etc.:** In order to arrive at the correct profit or loss, outstanding liabilities in respect of rent, rates, taxes, electricity, water, etc. must be brought into account. Otherwise, the profit arrived at will be more than what it actually is. In such cases, the auditor should inspect the ledger accounts, demand notes, receipt, etc. to find out what period is covered so that he can adjust the accounts for amounts payable during the year under audit.

3. **Audit Fee:** People differ in their views regarding the treatment of audit fee. Some argue that auditor's work is commenced after the close of the books and so audit fee should be treated as expense of next year. It should not be debited to Profit & Loss Account of the period under audit. But another argument about audit fee is that the auditor is paid for the audit of the accounts of the period under audit, so it is appropriate to debit the Profit & Loss Account of the period under audit though it has not been paid by the close of the year.

Though both the arguments appear to be sound, the following treatment is considered to be fair and reasonable-

1. If the audit work is commenced before the closing of books, the audit fees should be treated as outstanding liability.
2. If the auditor commences his work after the close of the book, it should be treated as expense of next financial year.

4. **Purchases:** Sometimes it happens that goods are received from the supplier at the close of the year but relative invoice is not received from the supplier. As purchase invoice is not received, no entry is made in the Purchases Book. For such purchases, the purchase account should be debited and credited to outstanding liabilities account. The auditor should compare the Purchases Book with the Goods Inward Register of the last month of the period under audit.

5. **Freight & Carriage:** If the clearing and forwarding agents do not render their accounts before the close of the period under audit, freight and carriage should be ascertained at the close of the year and brought into accounts. It is the duty of the auditor to see that no part of freight and carriage is left unrecorded.

6. **Commission Payable:** Salesmen and agents may be given commission on the basis of sales made by them. Normally, they are allowed to withdraw some amount against the commission from time to time, which are adjusted against the commission outstanding at the end of the year. At the date of the Balance Sheet, the amount due to the salesmen and agents should be calculated

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(after deducting the withdrawals already allowed) and only that amount should be shown as outstanding liability. If the agents have overdrawn their account the excess amount should be considered as advance given to them and should be shown as a loan to the agents on the asset side.

7. **Interest on Loans and Debts:** If on the date of Balance Sheet, interest on loans and debts is due but not paid, it must be shown as an outstanding liability. In such cases, it is the duty of the auditor to examine the past year's account, rate of interest, interest paid so far, and the agreement. He should examine the ledger account to see how much interest is yet to be paid. He should see whether proper entries are made in the books of accounts.

8. **Royalty Payable:** Sometimes, it so happens that the royalty may remain unpaid to a party. In such a case, the auditor should check whether proper provision is made regarding royalty due but not paid by the end of the period under audit.

CONTINGENT LIABILITIES

A contingent liability is one, which is not an actual liability but will become a liability on the happening of an event in future. According to **W.B. Meigs**, contingent liability is a "*Potential obligation, which may in future develop into actual liabilities or may dissolve without necessitating any outlay*".

It is important here to review what **Montgomery** says about contingent liability, which runs as follows:

"*The term Contingent liability should be used in the accounting sense to designate a possible liability of presently determinable or indeterminable amount which arises from past circumstances or action which may or may not become a legal obligation in the future, and which if paid, gives rise to a loss or an expense or an asset of doubtful value*".

Simply stated, contingent liability is not an actual liability but will become a liability on the happening of an event in future.

The following are the examples of contingent liabilities:

1. **Bills of Exchanges Discounted:** A bill receivable, which has been discounted with a banker, may be dishonoured on the due date and hence it may result in a liability because the amount will have to be paid to the banker who discounted it. Hence, if a bill receivable has been discounted with the banker, one is not sure whether the liability will arise not. If the bill is honoured, the question of liability will not arise. So when a bill is discounted with a bank, it becomes a contingent liability till the acceptor honours it. The amount of such liability is known and can be easily ascertained.

2. **Suits Pending for Damages:** Sometimes, a suit may be pending against the client which claim damages for breach of any contract or infringement of trade mark, etc. It is a contingent liability because if the Court decides it is payable, it will become certain. Otherwise, the client will not be held liable for the same.

3. **Other Contingent Liabilities:** They include the following:

1) Contingent liability arises due to the unexpired letters of credit issued by the bank.
2) Disputed but additional liability of income tax, and sales tax of the previous years.
3) Contingent liability on account of indemnity bonds issued by the bank on behalf of the client.

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Types of Contingent Liabilities

Contingent liabilities are of two types namely,

1. **Liabilities involving Expenditure or Loss:** Examples of this type of contingent liability are- a liability in a disputed case where damages may have to be paid, guarantee given by a company for loans or overdrafts granted to managed companies, speculative transactions on the stock exchange, forward contracts, etc.
2. **Liabilities involving Acquisition of an Asset of Corresponding Value:** Examples of this type of contingent liabilities are- goods purchased for future delivery or under an agreement of service. No note should be made in the Balance Sheet in respect of this type of contingent liability but if the amount involved is considerable, a note should be inserted at the foot of the Balance Sheet regarding this item.

Part I of Schedule VI of the Companies Act states that the contingent liabilities should be divided into two main categories. They are-

1. **The Liabilities in Respect of which Provision has been made in the Balance Sheet:** These items include those liabilities in respect of which the directors think that the liability will definitely arise in connection with a suit filed against the company though the amount may be uncertain a provision has been made in the Balance Sheet.
2. **The Liabilities in Respect of which No provision has been made in the Balance Sheet:** In respect of certain liabilities no provision has been made in the balance sheet but merely a note has been inserted at the foot of the Balance Sheet. Such liabilities include- bills receivable which have been discounted and which have not matured at the date of the Balance Sheet, arrears of fixed accumulated dividends, etc. If the company has a number of suits pending against it but the company is advised by its legal adviser that the ultimate legal and financial responsibility in regard to such suits is very negligible in relation to the total assets of the company, the amount is not extended in the money column.

The auditor should see that the requirements of the Companies Act regarding the contingent liability are complied with in the Balance Sheet on the liability side as stated above.

If the information required to be given under any of the items, or sub-items in this form is not included in the Balance Sheet because they are numerous, should be furnished in a separate Schedule or Schedules to be annexed to and form part of the Balance Sheet. The detailed explanation is given in Chapter 15, titled "**Company Audit - Presentation of Financial Statements**".

CONTINGENT ASSETS

The contingent assets include those assets, which may arise on the happening of an uncertain event. Usually, they are not shown at the foot of the Balance Sheet on the assets side. The following are the examples of contingent assets:

1. Uncalled share capital of a company.
2. Claim from the acceptor of a bills receivable, which has been discounted by the client from the bank but might be dishonoured.
3. Legal action for infringement of a copyright.
4. A claim for the refund of sales tax, octroi, etc.

Even though it is logical that as the contingent liabilities are shown in the Balance Sheet, the contingent assets also should be shown. This is because if they are not shown the true and fair state of affairs may not be disclosed by the Balance Sheet. However, the Companies Act does not require the disclosure of contingent assets in the Balance Sheet.

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CAPITAL AND REVENUE EXPENDITURE

Business transactions are classified into two categories such as capital and revenue. Capital expenditure is to be shown in the Balance Sheet and revenue expenditure is to be shown in the Profit and Loss Account. If correct allocation is not made between capital and revenue, the Profit and Loss Account will reveal a misleading figure of profits or losses and the Balance Sheet will not exhibit a true and fair picture of the financial affairs of a business. But, it is essential that profit and Loss Account should present a true and fair view of the profit earned or loss incurred during the year and Balance Sheet should present a true and fair view of the state of affairs of the business assets and liabilities on the date of the Balance Sheet. For this purpose it is essential that the capital expenditure and revenue expenditure should be distinguished clearly.

There are no hard and fast rules for making distinction between these two types of expenditure. Expenditure may be of revenue in nature in one case and of capital nature in the other. The allocation of an item to either of the heads can be made only after knowing all the facts of the case. The auditor should therefore see the basis on which the expenditure has been allocated between capital and revenue. It is the object with which the expenditure is incurred that nature of expenditure would be decided.

Capital Expenditure

Capital expenditure is one, which is incurred in the acquisition of assets of permanent nature, which are meant for the continual use in the business for the purpose of earning revenue. They are not meant for re-sale. Further the expenditure incurred to extend or improve the existing assets so as to increase their revenue earning capacity is also treated as capital expenditure. Generally, the following items are chargeable to capital expenditure:

1. Cost of acquiring a fixed asset.
2. Cost of installing plant and machinery, equipment, etc.
3. Cost of additions and extensions to existing assets.
4. Cost of structural improvements in case of existing assets resulting in enhancing the revenue earning capacity.
5. Expenditure incurred for the reduction in the cost of production or administration or selling and distribution.
6. Developmental expenditure incurred.

Wrong allocation of capital expenditure to revenue expenditure, will reduce the profit and also create a secret reserve. It will have far reaching consequences on the accounts of a firm. The Profit and Loss Account will not show a true and fair view of the profit of the company and the Balance Sheet will not show a true and fair view of the business. Therefore the auditor should ensure that proper allocation is made between capital and revenue. He should get a certificate from a responsible official as to the apportionment between capital and revenue. The proper allocation of expenditure between capital and revenue is a must from the point of view of accountancy, auditing, shareholders, and also the society.

Revenue Expenditure

All the expenditures incurred in the conduct and running of the business is called revenue expenditure. Besides, all expenses incurred in connection with repairs, renewals, etc. also fall under this category. In other words, it includes day-to-day expenses incurred in the routine conduct of the business as well as the items of expenses incurred to maintain an asset in a proper working

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condition. These expenses do not result in increasing the earning capacity of the firm. Generally, the following expenditure are treated as revenue expenses:

1. Expenses incurred in the day-to-day conduct and running of the business such as rent, wages, postage, salaries, interest, travelling expenses, insurance, and advertising, etc.
2. Expenses incurred for maintaining fixed assets in proper working condition such as repairs, renewals, and replacement of parts of machines.
3. Cost of goods that are purchased for consumption or resale like raw materials, stores, etc.
4. Expenses incurred in manufacturing, selling and distribution of the goods such as freight, cartage, coolie, salesman's commission, and advertisement.
5. Expenses incurred for covering the risk such as insurance premium.
6. Loss arising out of sale of fixed assets i.e., loss on sale of machinery.
7. Depreciation charged on fixed assets such as plant & machinery, furniture, motorcar, etc.
8. Annual lease rent paid for assets taken on lease.
9. Annual renewal fees paid for the renewal of licence, patents, etc.
10. Royalty paid for acquiring franchise.
11. Interest on borrowings.
12. Accidental losses such as loss on account of fire, etc.

If revenue expenditure is debited to the capital account, profit will be inflated and the company will be forced to declare high rate dividend than actual. It will result in the payment of dividend out of capital. It is against the provisions of the Companies Act. The auditor might be held responsible for the payment and asked to refund that amount by the Court. Therefore he should be cautious and see that proper allocation is made between capital and revenue expenditure. The auditor should also obtain a certificate to the effect that expenditure has been properly allocated between capital and revenue, from the responsible official of the company and mention that fact in his report also. The auditor's view is very significant in the matter of proper allocation of expenditure.

How to Allocate?

The allocation between capital and revenue expenditure should be done very carefully. It has been stated earlier that an item by itself cannot always be classified as revenue or capital. The above said principles should be applied to allocate an item of expenditure to revenue expenditure or capital expenditure. Further, the whole situation and facts must also be considered.

The total situation as well as facts are considered very important because the treatment of the same item can change under different situations. This can be explained with the following example- legal expenses, stamp duty, brokerage, carriage, wages, and repairs which are normally the items of revenue expenditure will be treated as capital expenditure when these are incurred in connection with the acquisition and development of fixed assets, similarly, ordinary repairs are treated as of revenue nature but if old machinery has been purchased and expenditure is incurred to bring it in proper working order, it will form part of the cost and will be capitalised as such. The important fact is whether the expenditure results in the improvement of earning capacity of the assets or not? If it does, then it is capital expenditure otherwise it is revenue expenditure. If the amount is spent for any of the purposes such as- acquisition of a fixed asset, addition or improvement to a fixed asset, improvement in the revenue earning capacity of the business, or on raising of the capital, it will amount to capital expenditure. Otherwise it will be revenue expenditure.

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Auditor's Duty

1. The auditor should familiarise himself with the nature of the business. This will enable him to know the nature of the expenditure and decide accordingly. For example, purchase of machinery by a businessman will be capital expenditure but for a machinery dealer it will be revenue expenditure.
2. He should get all the relevant data and documents related to the acquisition, repairs, additions, etc. of the assets.
3. He should obtain the vouchers of such expenses.
4. In case of controversial items, he should have discussion with the concerned official of the company before he forms any opinion.
5. He should ensure that the principles of accountancy have been observed accurately in classifying the expenditure as capital or revenue.

REVIEW QUESTIONS

Part - A

1. What is impersonal ledger?
2. What is unearned income? Give two examples.
3. What is revenue expenditure?
4. What are contingent liabilities?
5. What is contingent asset?

Part - B

1. How does an auditor vouch outstanding assets?
2. What is deferred revenue expenditure?
3. What is contingent liability? Is it necessary to make provisions in the final accounts for a contingent liability?
4. What is capital expenditure and how is it vouched?
5. How do you allocate between capital and revenue expenditure?
6. What are outstanding liabilities?
7. What are capital expenditures?
8. Explain the meaning of deferred revenue expenditure. Give three examples of deferred revenue expenditure and describe the auditor's duty with regard to this item of expenditure.

Part - C

1. What do you understand by outstanding assets and outstanding liabilities?
2. While vouching personal ledger, how can you, as an auditor, find out whether all outstanding assets are accounted for?
3. As an auditor how would you vouch the impersonal ledger?
4. What is deferred revenue expenditure? How would you verify this expenditure?
5. What are contingent liabilities? How would you vouch contingent liabilities? By what method would you satisfy yourself at the time of audit that all contingent liabilities have been disclosed in the balance sheet?
6. Discuss the manner in which the auditor does the vouching of impersonal ledger.
7. How would you ascertain that all outstanding expenses and all income received in advance have been provided for in the accounts? What effect would it have on the final accounts if these provisions were not made?
8. It is said that the contingent liabilities may be divided conveniently into two main classes. Give your views and if you also think so, state an example of each class. State also how each of them should be dealt with in the balance sheet of a company.

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VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES

9 CHAPTER

Meaning and Definition of Verification -Sub-functions of Verification - Objectives of Verification - Distinction between Vouching and Verification - Valuation of Assets and Liabilities - Verification of Different Types of Assets - Verification and Valuation of Liabilities - Contingent Liabilities.

MEANING AND DEFINITION OF VERIFICATION

The term verification refers to confirmation or proving the truth. It denotes the procedures that are carried out at the end of the period under audit in order to confirm the ownership, valuation, and existence of assets and liabilities at the date of the Balance Sheet. The term verification includes valuation also. With this introduction, we shall now see some of the definitions for the term verification as below:

Definition of Spicer and Pegler: According to **Spicer** and **Pegler**, "*The verification of assets implies an enquiry into the value, ownership and title, existence and possession, and the presence of any charge on the assets*".

Definition of Lancaster: In the words of **Lancaster**, "*The verification of assets is a process by which the auditor substantiates the accuracy of the right hand side of the balance sheet, and must be considered as having three distinct objects-*

(a) verification of the existence of assets,
(b) the valuation of assets, and
(c) authority of their acquisition".

From the above definitions, it is clear that verification is a broader term and includes valuation of the assets and liabilities also.

SUB-FUNCTIONS OF VERIFICATION

The verification function involves the following four sub-functions:

1. To see that all assets and all liabilities are clearly stated in the Balance Sheet.
2. To see that they are in existence on the date of the Balance Sheet
3. To see that the assets were acquired for the business and are free from any charge or mortgage and they are in the name of the client.
4. To see whether both the assets and liabilities are accurately valued.

OBJECTIVES OF VERIFICATION

The main objectives of verification are as below:

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1. Examining the ownership, possession, and title of the assets appearing in the Balance Sheet.
2. Ascertaining the existence of the assets appearing in the Balance Sheet.
3. Verifying the fact whether assets are free from charge or not.
4. Detecting the frauds and irregularities, if any, in the books of accounts of the concern.
5. Ensuring the arithmetical accuracy of the books of accounts.

DISTINCTION BETWEEN VOUCHING AND VERIFICATION

The points of difference between vouching and verification are given in Table 9.1.

S.No.	BASES OF DIFFERENCE	VOUCHING	VERIFICATION
1.	Nature of Work	Vouching checks the entries as to the transactions recorded in the books of account.	Verification examines the assets and liabilities given in the Balance Sheet.
2.	Basis of Examination	Vouching is based only on the documentary examination.	Verification is based not only on documentary examination but also it carries on physical inspection.
3.	Period	Vouching is done for the whole year.	Verification is done at the end of the year only.
4.	Utility Factor	Vouching indicates that a particular asset must be possessed by the concern.	Verification certifies the existence of assets and liabilities at Balance Sheet date.
5.	Valuation	Vouching does not primarily concerned with valuation.	Verification includes valuation also in its scope.
6.	Personnel Involved	Audit clerk does vouching of books of accounts.	The auditor himself does verification.

TABLE 9.1 – DIFFERENCE BETWEEN VOUCHING AND VERIFICATION

VALUATION OF ASSETS AND LIABILITIES

The term valuation refers to the critical examination and testing of determined values of assets by the auditor based on generally accepted accounting principles and conventions. The accuracy of the Balance Sheet and Profit and Loss Account depends very much upon the valuation of assets and liabilities in a proper manner. Both under valuation and over valuation of assets and liabilities would exhibit a wrong picture about the financial position of the concern. Hence, the auditor should see whether all the assets and liabilities are shown in the Balance Sheet at their proper value.

Auditor's Duty regarding Valuation of Assets & Liabilities

An auditor is not a valuer and he cannot be expected to act as such. Actually, the proprietors or responsible officials of the concern who have a practical knowledge of such assets make valuations. An auditor's duty is confined to testing the valuations as far as he can and in this way satisfying him with the position shown to be correct. In **Kingston Cotton Mills Co. Case, it was** held that "*Although it is no part of an auditor's duty to value the assets and liabilities, yet he must exercise reasonable skill and care in scrutinising the basis of valuation. He should test the accuracy of the values put by the officers of the business. In any case, the auditor cannot guarantee the accuracy of the valuation*".

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From the above discussion, it is clear that in the absence of suspicious circumstances, if he relies on trusted officials of the company an auditor is not liable. However, it does not mean that he will be free from his liability if assets are incorrectly valued by the officers of the company as it suits to the management. An auditor is no doubt concerned with values set against the assets, because ultimately he is to certify that final accounts reveal a true and fair view of the state of affairs of the concern. Therefore, an auditor should exercise reasonable care and skill, analyse all the figures critically, inquire into the basis of valuation from the technical experts, and satisfy himself that the different assets shown in the Balance Sheet are properly valued in accordance with the generally accepted conventions and accounting principles. If he is satisfied with the methods of valuation of the assets, he is free from his liability. It has been observed, "*Financial accounts are largely a matter of convention, judgement and opinion, not a matter of certainty. The balance sheet can never show the real financial position, but only a fairest possible estimates of the financial conditions*".

An auditor can never claim that the Balance Sheet is absolutely correct.

Kinds of Values

Some of the interpretations that are used in the valuation of assets are given below:

1. **Cost Price:** Cost price refers to the price paid for the acquisition of an asset. It includes the expenses incurred in the purchase of an asset and its installation.
2. **Market Value:** Market value is the value, which an asset can fetch in the market when sold.
3. **Replacement Value:** Replacement value is a price at which a particular asset can be replaced. It includes expenses like commission, freight, etc.
4. **Book Value:** This is the value at which an asset appears in the books of accounts. Usually, assets appear in the books at cost minus depreciation written off so far.
5. **Realisable Value:** Realisable value is one, which will be realised in the market and received from the sale of an asset. It is normally used in the valuation of existing assets.
6. **Going Concern Value or Historical Value:** It is also called commercial value or token value or conventional value. It is equivalent to the cost less a reasonable amount of depreciation written off.
7. **Scrap Value:** It refers to the value, which may be obtained from the asset if it is sold as scrap.

Basis of Valuation

While valuing the assets the auditor must keep in mind the following points:

1. Original cost of the assets.
2. Expected working life of the assets.
3. Wear and tear of the assets.
4. Scrap value of the assets.
5. Chances of the assets becoming obsolete.

Methods of Valuation

For the purpose of valuation, assets are classified under five main categories as shown below:

1. Fixed Assets.
2. Current Assets.

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3. Wasting Assets.
4. Fictitious Assets.
5. Intangible Assets.

1. Fixed Assets: Fixed assets are those assets, which are purchased for the permanent use of the industrial concerns. They are continuously used in the concerns. Earnings of the concern depend upon these assets. The utility of these assets remains so long as they are in working condition. They are neither meant for resale in the ordinary course of business nor consumed totally or partially in the business.

Plant & machinery, land & building, furniture, etc. are some of the examples of fixed assets. Of them, land is not subjected to depletion in value and so it is usually valued at cost price. The other fixed assets are valued at historical value because they are acquired for the running of a business and put to their repeated uses. They are valued at cost less a reasonable depreciation written off and any fluctuation in their market value is not considered for their valuation. Further, as tney are going to be continuously used, their realisable value is also need not be taken into account.

2. Current Assets: Current assets are those assets, which can't be put to constant uses. They are also called as floating assets or circulating assets. They are meant for resale. They are either purchased or produced or processed for the purpose of sale. Closing stock, bills receivable, book debts, cash, bank balance, etc. are some of the examples of floating assets. Current assets such as book debts, bills receivable, etc., are normally valued at book value. In case of book debts, a provision is made for bad and doubtful debts. Raw materials and semi-manufactured goods are valued at cost. The closing stock of goods is valued at the date of the Balance Sheet either at a cost price or market price whichever is lower.

3. Wasting Assets: Wasting assets such as mines, quarries, oil wells, etc. are of fixed nature. Wasting assets are found in certain industries only. If we look at the terms of the decision of the case of **Lee V. Nauchatel Asphalte Co. Ltd. (1889)** it appears that there is no necessity to provide depreciation on wasting assets. But as a matter of principle, the theory propounded in the case does not hold good. Wasting assets exhaust by working and hence the process involves depletion of the capital employed. Hence, a charge should necessarily be made to maintain the capital employed so as to exhibit a true and fair value of the assets for the purpose of cost accounting.

However, it is difficult to ascertain how much of the mine is exhausted and how much mineral remains more. Hence, wasting assets are shown in the Balance Sheet at their original value and provision is made for depreciation or depletion on the basis of their estimated exhaustion.

4. Fictitious Assets: Fictitious assets are those assets, which are not physically visible, though, of course, money is spent on them. The examples of such assets are- preliminary expenses in a new company, special advertising expenses, development expenses, debenture discount and issue expenses, discount on issue of shares, share issue expenses, etc. These items are really items of expenditure not represented by actual values and so have no exchange value.

5. Intangible Assets: Intangible assets do not have their form. Hence, they are not visible in their concrete form. However, they are equally valuable for a business concern like any other assets. They are actually fixed assets though they do not have any concrete form. Goodwill, patents, copyrights, trademarks, etc., are some of the examples of this kind of assets. They are more or less treated as fixed assets for the purpose of valuation.

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VERIFICATION OF DIFFERENT TYPES OF ASSETS

We shall now discuss the procedure, which the auditor follows while verifying various assets separately.

1. Fixed Assets

These assets are called capital assets. They are required permanently for the conduct of the business. They are not purchased for re-sale. We shall now analyse the verification of these assets.

1) Goodwill

Goodwill is an intangible asset. It is the value of the reputation of the firm. It enables the firm to earn more than the normal rate of profit. It has no physical existence as such. It does not diminish in value with use. It has the potentiality of self-growth. It can be raised merely by book entries. Goodwill is calculated and shown in the Balance Sheet only under the following circumstances:

1. **At the Time of its Purchase:** The amount of goodwill is equal to the difference between the total purchase price paid for the business and the net assets (i.e., Assets - liabilities) purchased.
2. **At the Time of Revaluation of Whole of Assets:** Sometimes, companies revalue whole of their assets and raise goodwill account in their books. In such cases also, the goodwill so raised will be shown in the Balance Sheet.
3. **At the Time of Writing off the Capital Loss or the Debit Balance of Profit & Loss Account:** Sometimes, the goodwill acquired by the company and written off as such has been later brought back to accounts to write off the debit balance in the Profit & Loss account or the capital loss which the company incurred subsequently.
4. **At the time of Admission, Retirement or Death of a Partner in case of Partnership Firms:** In case of partnership firms, goodwill is calculated and shown in the books when a new partner is admitted or an old partner dies or retires.

In case of purchase of the business, the auditor should verify it with the help of the agreement made with the vendor, which shows the price paid for it. However, if the amount of goodwill is not specifically mentioned, it is to be treated as the difference between the purchase price paid for the business and the net assets taken over.

In case of revaluation of assets, which has raised the goodwill account in the books of a company, the auditor should refer the basis on which the assets have been revalued. While in the case of goodwill, which has been written off but later brought back to write off capital loss or the debit balance of Profit & Loss Account, he should investigate the period over which the goodwill was written off. He should also ascertain the amount of goodwill. He should also see whether debtors as well as shareholders approved it by passing necessary resolutions in their meeting.

In the case of partnership firm, he should verify the Partnership Deed. He may also verify the changes made in the goodwill account from time to time based on the provisions made in the Partnership Deed.

2) Patents

Patent is an official document, which gives an inventor exclusive right for years to make, use or sell his invention. It must be valued at cost less depreciation. The valuation basis must be specified in the Balance Sheet. It should be written off in a period of 20 years after which the right automatically lapses unless the term is extended. He must note the period expired and the remaining

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life of the patents. Proper distinction must be maintained while charging the cost of the patent to capital and revenue.

In order to verify the patent rights, auditor would examine certificates of registration, assignment deeds, last renewal certificates, etc. He should see whether the patent is registered in the name of the client. If patents have been obtained in the name of some of the employee's of the firm, he must see that it is properly assigned in favour of the firm. If the number of patent is large, he can ask his client to prepare a list of patents, which the firm is having with details like date of acquiring patents, registered number, and the period yet to expire. He should be careful in checking that none of the patent rights have lapsed. If so they should be written off. Where any patents newly obtained it can be verified with the help of the cash receipts for the same. He should also examine the last several fee payment certificates to satisfy himself that patents have been renewed at the prescribed time.

3) Copyright

Copyright refers to the exclusive right to do or authorise the doing of certain acts specified in the Copyright Act, 1957 in respect of a work such as literary, dramatic, and musical work, computer programme, artistic work, cinematograph film and sound recording. It is the legal right given to an author, which prohibits the publication of the work by other persons. The author of the work shall be the first owner of the copyright. The owner of the copyright may assign it to any person. The duration of the copyright is the lifetime of the author and sixty years after his death.

The procedure followed for the verification of copyright is as follows:

1. If the copyright is obtained by outright purchase from the author of the book, the documents such as the agreement entered into with him, receipts, etc. are to be scrutinised to know the purchase amount.
2. If it is purchased on the basis of royalty, copyright has no value. The amount of royalty paid is to be debited to the Profit & Loss Account as an operating expense.
3. If copyright is obtained for a few years, its full value should be written off in the form of depreciation before the expiry of the said period.
4. Copyrigt that has become obsolete should not be valued and shown in the Balance Sheet. Hence it is clear that copyright is to be valued only based on its profit earning capacity.

If there are many copyrights with a business, the author should call for a Schedule of copyrights from the client for the purpose of verification. If the sale of the publication is very low or nil, the copyright should be written off. In the Balance Sheet, copyright should be shown at cost less amounts written off from time to time.

4) Trade Marks

According to Sec. 2(zb) of Trade Marks Act, 1999, "*Trade mark means a mark capable of being represented graphically and which is capable of distinguishing the goods or services of one person from those of others and may include shape of goods, their packaging and combination of colours*". The assignment deed duly endorsed by the office of the Registrar of Trade Marks should be examined in order to verify the trade mark. Trade marks can also be acquired from others like copyrights. If it is so, the expenditure incurred for the acquisition of trade mark should be examined with reference to registration fees, payments made to designers, etc. The auditor should see whether renewal fee is paid each year at right time and it should be treated as revenue expenditure. However, any expenditure incurred in its acquisition should be treated as capital expenditure. Therefore, he should see whether distinction is made between the capital and revenue expenditure.

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As far as the valuation of trade mark is concerned, revaluation made is considered as the most suitable method. The auditor should see that it is properly valued and shown in the Balance Sheet.

(f) Land & Building

Assets like land, building, etc. can be divided into two categories such as-

1. Freehold Property, and
2. Leasehold Property.

We shall new discuss the verification procedure of these categories of assets separately.

1. **Freehold Property:** As land is a non-depreciable asset, it is better if it is shown separately in the Balance Sheet. In other words, it should not be shown along with buildings because building is a depreciable asset whereas land is a non-depreciable asset. The verification procedure is as follows:

1. The auditor should examine the title deeds in order to ensure that they are in the name of the client.
2. In case the property is mortgaged, he should obtain a certificate from the mortgagee or his solicitor to the effect that the title deeds are in their possession. He should also enquire whether there is any second or subsequent mortgage or not.
3. If it is purchased, correspondence and broker's note should be examined. If the purchase is effected through auction the auctioneer's account should be checked.
4. If the client has constructed the building, the auditor should examine the certificates received from the builder, the contractor, the architect and other necessary papers and documents.
5. If the building is a newly purchased one, the value of building can be ascertained by vouching the amount paid to the contractor. If it is partly constructed, by obtaining architect's certificate, its value can be determined.
6. If the client's own staff members are also engaged in its construction, the auditor should see that a reasonable basis of allocation of wages, supervisor charges, etc. has been adopted.

2. **Leasehold Property:** If the land or building is acquired by the business for a fixed duration on lease, the property is said to be leasehold. Auditor should see that separate accounts are maintained both for freehold and leasehold properties.

The amount of premium paid in order to acquire the lease, the expenses incurred on the improvement of the building, etc. should be capitalised and written off over the life of the lease. The royalty paid every year should be treated as revenue expenditure and debited to the Profit & Loss Account. The cost of leasehold property should be written off on straight line basis.

The auditor should take the following steps to verify the leasehold property:

1. The auditor should inspect the lease agreement to find out value of the property and its duration. He should see that the lease agreement is registered with the Registrar and certificate testifying the validity of the same has been obtained from the client's legal advisor.
2. He should see that the terms and conditions of the lease are duly complied with.
3. The annual charge for depreciation will be arrived at by dividing the total cost by the term of the lease. The auditor should see whether amount written off is sufficient to provide for depreciation at the end of the term.

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4. If the property is sub-let, the auditor should examine the agreement entered into with the sub-lessee.
5. If the asset is of building, the tax paid, and repair expenses made for it should be treated as operating expenditure. The auditor should see whether they are treated so.

6) Plant & Machinery

Generally, business concerns, maintain a Plant Register in order to keep a detailed record of plant and machinery, which they possess. The auditor should examine the Plant Register in order to know about the cost of plant and machinery, provision made for depreciation on plant & machinery, etc. He should also ask for a Schedule of various plants possessed by the firm for making comparison between the details given in the Plant Register with the Schedule. The machinery purchased during the year should be vouched by reference to the invoice to the relevant vouchers. In case a part of the machinery is sold out, it should be seen that necessary entries have been passed at proper places and profit or loss if any arising out of sale is duly recorded.

If plant and machinery is kept in any of the foreign countries, the auditor should obtain a certificate to that effect from the local auditor. He should verify the existence of the asset by his personal inspection. He should look to the details given in the Plant Register in order to see that there is any mortgage or charge on the asset.

It is very common, especially in large scale concerns, to purchase plant and machinery under hire purchase agreement. In such cases, the auditor should examine the relevant agreement to ascertain the mode of payment, amount of each instalment, number of instalments, and the time at which the title will pass. The hire purchase price includes interest, which should be charged to revenue account. The net cash purchase price should be capitalised. Depreciation should be charged on the entire cost price of the asset.

In case of the imported machinery, the auditor should verify the agreement with the foreign supplier to note the terms and conditions on which the machinery has been supplied, the import licence covering the imported plant, copy of the invoice, documents relating to customs duty, and permission of the RBI authorising the remittance.

The plant and machinery account should be shown in the Balance Sheet at cost less depreciation after making proper adjustments regarding new purchases of machinery and sale of old machinery during the year under audit. The auditor should see whether the plant & machinery account is shown properly in the Balance Sheet as stated above.

7) Furniture, Fixtures & Fittings

In practice furniture, fixtures and fittings are different items. But they all are shown usually as one asset and verification also done by the auditor as one item only.

Furniture is a movable asset. It can be moved from one place to another easily. Examples of furniture are- chair, table, desks, etc. Fixture is an asset affixed tightly to the ground. Galleries in colleges, equipments affixed to the table in science laboratories, etc. can be cited as examples here. Fittings are those items that are fitted on the walls. Examples of fittings are- electric fittings, fans, etc.

Generally, business concerns maintain Furniture Stock Register. The auditor should verify the Furniture Stock Register as to whether it is properly balanced and balance is clearly shown therein. He should verify the balance of assets as well as additions made thereto by comparing original invoices with furniture stock register. Auditor should carefully scrutinise the sale of old

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machinery if any made during the year. He should also verify the profits or losses arising from such sales. Any expenditure incurred while purchasing these assets should be capitalised. Repairs to furniture are to be charged to the Profit & Loss Account. But freight and carriage spent on bringing the furniture to the factory should be charged to the furniture account and not to the Profit & Loss Account.

Furniture, fittings & fixtures are valued at cost less depreciation at a reasonable rate. He should look into the adequacy of depreciation charged on them. He should also note that the depreciation is so provided every year that the entire asset must be written off by the expiry of its lifetime.

8) Motor Vehicles

Motor vehicles account is to be maintained separately. If the concern possesses a large number of vehicles, it can maintain a separate register called Motor Vehicles Register. Motor vehicles should be shown separately in the Balance Sheet.

The auditor may obtain a Schedule of motor vehicles and compare it with the Motor Vehicles Register. He should examine the Registration Book for each vehicle. He should compare the registration number and description given in the Registration Book with those given in the Motor Vehicles Register. He should check the Registration Book and Licences and make sure that the vehicles are registered in the client's name. Suppose, a vehicle is not registered in the name of the client and it is registered in the name of some other person, the auditor should scrutinise the letter confirming the arrangement and make sure that there is no charge on the vehicle in favour of such a person. He should also examine the insurance premium receipts to ensure that the vehicles are fully insured against accidents, third party, riots, theft, etc.

Motor vehicles are valued at cost less depreciation. The auditor should verify the adequacy of the depreciation. The maintenance charges and yearly renewal fees are to be charged to revenue account.

9) Livestock

Firms maintain certain animals like horse, bullock, cow, etc. also for transporting goods from one place to another. Normally, for this type of assets, firms maintain a separate register in which the details of all animals as to their cost, life, etc. are recorded. The auditor should check this register with inventory. He should also obtain a livestock Schedule duly signed by a responsible official for the purpose of verification.

As regards their valuation, the auditor should see whether they are revalued annually. In case of any sale or death, the loss suffered by the firm due to such sale or death is to be written off. The value of livestock is to be shown separately in the Balance Sheet.

10) Assets Acquired under Hire Purchase or Instalment Purchase

Assets that are acquired on hire purchase or instalment agreement should be properly recorded. Every year the instalment has to be paid and the amount so paid is to be recorded in the books of accounts. Where the asset has been shown at its full value in the Balance Sheet, it is necessary to show the unpaid instalments on the liability side.

The auditor should examine the necessary agreement and should see that the expenditure has been distinctly allocated as capital and revenue. He should see that the interest paid on the unpaid balance has been charged to the Profit and Loss Account. The provision for depreciation should

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be made on the basis of the full cash price and the asset should be shown in the Balance Sheet after deducting the amount of depreciation.

11) Loose Tools

Loose tools consist of small tools, moulds, etc., which have shorter useful life. They are also priced low. Hence, all such tools are shown in one account. The auditor should obtain a list of loose tools, which should be duly authorised by some responsible officer.

Revaluation method is considered as one the most appropriate methods to value loose tools. In case of loose tools the difference between the cost price and the current price should be taken as depreciation/loss, which is to be charged to the Profit and Loss Account. If the loose tools are made in the business itself, the cost of such tools should be verified from the Cost Sheet certified by the Chief Engineer of Works, in which case the valuation should not be made at a price more than the cost incurred.

12) Stores & Spare Parts

Stores and spare parts consist of materials, which are purchased for consumption in the business. They are not meant for re-sale. Stores include- lubricants, grease, dyes, fuel, etc. whereas spare parts are stored in order to maintain the machinery in proper working order. The stores consumed are debited to Manufacturing Account and spare parts used are debited to the Machinery Account. The balance of stores and spare parts in hand should be shown in the Balance Sheet at cost price. These assets are not subjected to depreciation and so no depreciation should be provided for them. But loss if any arise due to its breakage, waste, or worn out should be duly written off. They should be revalued every year.

The auditor should obtain an inventory of stores and spare parts, which is duly certified by a responsible officer. If possible, he should physically verify the stock of stores and spare parts in order to check their existence.

2. Investments

Investments include shares, debentures, bonds, Government securities, stock, etc. Investments constitute an important asset to Banks, Insurance Companies, Financial Institutions, Investment Companies, etc. As per the Companies Act, Investments are to be shown in the Balance Sheet next to fixed assets.

If the number of investments is large, the auditor should ask for a Schedule of Investments held by the client. Such a Schedule should show information regarding name of the securities, date of purchase, their nominal value, cost price, and market price at the date of Balance Sheet, etc. The Schedule so obtained should be examined by reference to the relevant ledger accounts. The auditor should see that the asset has been shown distinctly and properly in the Balance Sheet according to the Schedule VI in the Part I of the Companies Act, 1956.

In case of investments purchased during the year, the auditor should check whether all the directors in their meeting have passed the resolution sanctioning the investments unanimously. The broker's bought note, or allotment letter received from the company, should also be verified.

In case of investments, which have been sold after the Balance Sheet date but before the audit date, the sales should be vouched. Sec. 372 of the Companies Act provides for ceiling in purchase or sale of investments. The auditor should see whether investments made by the company are

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within the limits prescribed in Sec. 372 of the Companies Act. If the company possesses bearer bonds as one of its investments, the auditor should verify them to see that coupons are attached for the net payment of interest.

In the Balance Sheet of a joint stock company, the investment in the government securities and share and bonds are shown separately. In case of investment in shares of other body corporates, each class of share should be shown differently indicating specifically whether they are partly paid up.

The Auditor should obtain a certified list of all investments, whether in hand, pledged or given as security. The auditor should actually inspect them all in one sitting as it was held in the case of City **Equitable Fire Insurance Company Ltd. (1924).**

If the investments are held by a trust on behalf of the company, the auditor should obtain the trust deed or certificate from the trustee and verify the same. If they are entrusted with the banks for safe custody he should get a certificate to that effect from the bank, which should also state that they are free of charge.

The auditor should verify the amount of interest and dividend collected with the help of General Ledger, Cash Book and Bank Pass book if the bank collects it.

In the case of a banking company, the auditor should examine simultaneously all the investments of the bank as well as those deposited as security by borrowers.

The auditor should ensure that the investments are registered in the name of the client and they are free from any charge. He should rely on the relevant vouchers and certificates to do so.

If the investments are held as fixed assets in order to earn regular income, they should be valued at cost price. On the other hand if they are held as current assets, as in the case of finance companies, they should be valued at cost price or market price whichever is lower.

3. Current Assets, Loans and Advances

Next we shall discuss the verification of current assets which include-

1. Cash in Hand.
2. Cash at Bank.
3. Book Debts.
4. Bills Receivable.
5. Loans and Advances.
6. Stock-in-trade.

Besides, it is specified in the Companies Act that the stores and spare parts, and loose tools are also should be shown as current assets. But as we have already discussed the verification of these items under the heading fixed assets, they are not discussed again here. We shall now discuss the verification procedure of other current assets hereunder.

1) Cash in Hand

The auditor should actually visit the business concern at the close of financial period or on the following morning and actually count the cash in hand in one sitting and compare it with the balance as shown in the Cash Book. This will enable him to avoid any fraudulent manipulation i.e., making up of shortage of one account from the balance in another account.

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The auditor should also count cash, stamps, I.O.U. (I Owe You) slips in hand. The firms use I.O.U. slips to give temporary advances to the employees. If he found such slips, he should verify them carefully. The auditor should look into the details about their genuineness and get them initialed by some responsible officer.

Actual verification of the cash in hand has been considered to be the most important part of the auditor's duty. If he does not actually verify the cash he will be held responsible as it was held in the case of **The London Oil Storage Company Ltd. *V.* Sear Hasluck & Co.**

Where there is unusually heavy cash balance at the end of the year, it is the duty of the auditor to draw the attention of the management to the dangers, which may arise there from. There is no doubt that the auditor should ascertain whether his client really needs the holding of so much of cash by considering his daily cash requirements. He should also check the system of making payments and safety arrangements provided for the protection of cash in hand.

If the entity under audit has any branch, in order to verify the cash balance at branches, the auditor should check remittance from branches to the head office account from branch returns.

A good internal check system, the practice of depositing cash balance every day, making payments by cheques, not holding large sums in hand for long period, and adopting imprest system of petty cash, etc. are some of the methods, which are highly useful to prevent the manipulation of cash in hand in the business.

2) Cash at Bank

In verifying bank balance, the auditor should compare the balances as shown in the Pass Book with those shown in the Cash Book. If there is any difference, he should prepare a Bank Reconciliation Statement in order to find out the causes for such a difference.

There is a possibility of presenting a fictitious Pass Book to the auditor. If he has any suspicion in his mind that Pass Book presented to him may be of fictitious one, he should obtain a letter of confirmation or a certificate directly from the Bank. Otherwise, he can himself check accounts in the Bank Ledger.

Besides, he should obtain separate certificates for Fixed Deposit Account, Current Account, Savings Bank Account, etc. from the Bank. If the concern under audit has accounts with more than one bank, the auditor should verify all those accounts.

3) Book Debts

The Companies Act, 1956 states the order in which the book of debts of a company should be shown in the Balance Sheet. It is as follows:

1. Debts considered good for which the company is fully secured.
2. Debts considered good for which the company holds no security except the debtor's personal security.
3. Debts considered bad or doubtful.

The auditor while forming an opinion as to whether the debts are good, doubtful or bad, should keep the following things in mind:

1. **The Age of Debts:** The age of debts is one of the important factors to be considered by the auditor to decide whether a particular debt is good, bad, or doubtful. This is because if the payment is made within a reasonable period it indicates the sign of good and *vice versa*.

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2. **Regular Payments:** If payments are made regularly, the accounts may be considered good. Otherwise, it may be considered as doubtful.

3. **Heavy Dishonoured Bills:** Dishonoured bills are always considered to be a sign of weakness. Likewise, returned cheques and renewed bills should be viewed with suspicion that they may become doubtful.

4. **Noting on the Accounts:** Notes on the accounts like "**In Solicitor's Hands**", "**In Liquidation**", "**Address Unknown**", etc. clearly indicate that they are doubtful.

5. **A Comparison of Bad Debts, Budgeted, and Actual:** It provides a basis for considering a particular debt as bad, doubtful or good. By making such a comparison for a number of years, opinion can be formed about the nature of debt.

While verifying book debts, an auditor should follow the following procedure:

1. The auditor should obtain the list of debtors duly certified by the responsible official and scrutinise its accuracy.
2. He should obtain the confirmation letters of the statement of accounts directly from debtors and the same should be verified to check the actual existence of debtors. He should pay special attention to those balances for which confirmations are not available.
3. The sales ledger balance should be checked with the Debtor's Ledger, Sales Book, Sales Returns Book, Cash Book, etc.
4. He should see that the book debt balances do not include the amounts due in respect of goods out on sale or return basis.
5. He should see that the book debts shown in the Balance Sheets are recoverable.
6. He should obtain a duly certified statement classifying between good debts, secured debts, unsecured debts, current debts, bad and doubtful debts, and debts outstanding for a period exceeding six months.
7. He should see that adequate provision has been made for bad and doubtful debts.
8. In the case of company accounts the auditor should see that its debtors are classified as prescribed by the Companies Act of 1956 and shown in the Balance Sheet in the same order.

4) Bills Receivable

In case of bills receivable, the auditor should adopt the following procedure to verify it:

1. The auditor should verify Bills Receivable Book with bills receivable in hand for which he should call for a certified Schedule of bills in hand.
2. The totals of the Schedule should be checked by reference to the accounts in the General Ledger.
3. He should examine each bill to see that it is properly drawn, signed by the acceptor and is also properly stamped.
4. He should verify the bills met after the close of financial year but before audit by vouching the cash received and entered in the Cash Book.
5. Bills discounted should be examined by verifying the entries made in the Cash Book with those in the Bills Receivable Book.
6. The auditor should see that a note for the contingent liability in respect of bills discounted appears on the Balance Sheet.

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In case bills deposited with a bank for safe custody or for security of a loan, they should be verified with the help of a certificate obtained from the concerned bank, in order to confirm their existence.

In case bills have been retired before the date of the Balance Sheet, the proceeds received there from should be checked by reference to the Cash Book.

5) Loans & Advances

1. **Loans:** Loans may be divided into two kinds. They are- (1) Secured Loans, and (2) Unsecured Loans. Secured loans can again be divided into two types such as- (1) Loan against Security of Land & Buildings, and (2) Loan against Movable Properties. We shall now discuss the verification procedure of these kinds of loans under three heads as shown below:

1) **Loans against the Security of Land and Buildings:** If the company grants any loan against the security of land & buildings, the auditor should examine the Memorandum and Articles of Association of the entity to see whether it is empowered to lend money against land and property. The auditor should inspect the Minutes of the meeting of the Board of directors. If the borrower is a limited company, the auditor should also ascertain that borrowing company has borrowed within its borrowing limits. If the land or property has been mortgaged the auditor should first examine the Mortgage Deed and see whether the mortgage is properly executed in favour of his client. He should examine the title deeds relating to the property. The auditor should also see that the mortgage is duly registered. If the borrower is a limited company, he should examine the certificate from the Registrar of Companies regarding the registration of charge.

In order to see whether there is adequate margin of security, the auditor should obtain a certificate as to the value of the property from the valuer. If the loan is secured against a second mortgage, the auditor should see whether the first mortgagee has been duly informed of the second mortgage. He should also see that the first mortgagee has the title relating to the property.

The particulars of loan such as amount of the loan, rate of interest, date of receiving interest and the period of the loan are to be verified. Auditor must see that the interest is regularly received on the due dates. In case of overdue interest, auditor should see whether adequate provision has been made in respect of doubtful recovery.

The auditor should see whether the property is insured against its full value. He must also check up the last receipts of the fire insurance premium in order to see the policy is in force or not.

The auditor should get the loan amount confirmed by the borrowee.

2) **Loan against Movable Properties:** Movable properties include stock, shares, goods, insurance policy, bonds and debentures, etc. Loans are also granted against the security of these movable properties. We shall now discuss the verification procedure of this kind of loans.

If loan is granted against the security of company shares, debentures, etc., the auditor should obtain a list of stock and shares, which have been held as security in order to check whether they have been transferred in favour of his client. He should examine the valuation of securities and find out the margin between the loan and the present value of the security. If he finds that the margin is not adequate, he should ask his client to demand more security. The auditor should verify as to the marketability of the security. Partly paid shares should not be accepted as security. Above all, the auditor should get a written acknowledgement from the borrower regarding the amount of loan on the date of the Balance Sheet.

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In case of loans, which have been given against the security of a Godown keeper's Receipt, such a receipt should be examined. If the goods are lying at dock or in bonded warehouse, the auditor should see that the dock warrant or the warehouse certificate is in the name of the client. He should examine such certificate also. Further, the auditor should see that the borrower has paid the rent for the warehouse or godown. If the loan has been advanced against the goods-in-transit, Railway Receipt, Truck Receipt or Bill of Lading together with a Letter of Hypothecation, insurance policy and invoices, duly endorsed in favour of his client, should be inspected.

If loans are given against the security of Insurance Policy, the auditor should check the date on which the premium of the policy becomes due and should inspect the last receipt of the premium paid in order to find out whether the policy is in force or not. It the premium has been paid by his client to prevent the policy from lapsing, the amount so paid should be debited to Loan Account. In such a case, the auditor should see whether it has been correctly treated in the accounts. The auditor should ascertain the surrender value of the policy by writing to the insurance company and see that the loan advanced is within the surrender value. The auditor should also see that the notice of assignment of the policy has been given to the insurance company.

3) **Unsecured Loans:** Unsecured loans are given against the personal security of the borrower. In case of unsecured loan, the auditor should make an enquiry regarding the financial position of the surety, because the value of the security depends on his financial position. He should see that any change in the terms of the loan is made without the permission of surety. If it is so, it will discharge the surety. Hence, the auditor should see no such change has been made in the terms of the loan. Promissory Note should be examined with a special attention to the date of maturity.

2. Advances: Advances include prepaid expenses such as prepaid insurance premium, telephone rent, rates, etc. In case of these prepaid expenses, the auditor should get a list of these items and should compare the details in the list with the entries made in the Journal as well as in the Ledger. The receipt issued by the relevant authorities for the payments made towards these items also should be vouched.

6) Stock-in-Trade

Stock-in-trade is the lifeblood of any business. It comprises of items such as stores and spares, loose tools, raw materials, work-in-progress, finished goods, scrap, and by-products.

Physical Verification of Stock-in-trade

Goods are easily subject to misappropriation and manipulation. Very often firms use stock in trade as one of the methods to inflate or deflate profit by understating or overstating the value of stock. If stock-in-trade is incorrectly recorded, verified or evaluated, the resultant profit or loss for the period will be incorrect. It will also affect the Balance Sheet and the assets, and net worth will present a wrong picture. If stock-in-trade is overstated, it may lead to payment of dividends or other expenses based on inflated profits. If it is understated, secret reserve will be created, and it may also lead to a fall in share values due to disclosure of low profits. Hence the auditor must verify the existence of stock and also its correct valuation. He should be extraordinarily cautious in verifying the stock. He should see that they are valued as per the accepted principles of accountancy. If proper accounts are prepared, he will not find any difficulty in verifying and valuing the assets. But mostly this is not done. Besides, auditors find it difficult to verify each and every item of stock physically because of lack of technical knowledge as well as limited time.

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Therefore, normally they rely upon test checks to ascertain the accuracy of stock-in-trade. In the case of **Kingston Cotton Mills Co., Ltd., (1896), Justice Lindley** observed as follows:

"*It is no part of the auditor's duty to take stock. No one contends that it is ..... He must rely on other people for details of stock-in-trade*".

The learned Judge in the case of **Irish Wollen Mills** expressed the similar view, which is as follows:

"*There was certainly no duty cast on the auditor to take stock. What he did was to have the calculation checked in his office and this was done with the proper care*".

From the above views, it is clear that it is not the duty of the auditor to take the stock, and that he is not guilty of negligence if he accepts the certificate of a responsible official in the absence of suspicious circumstances. To contradict this view, in **Westminster Road Construction & Engineering Co. Ltd.,** it was held that "*The auditor is liable for not detecting over-valuation of assets or omission of liabilities from the balance sheet, if such could be detected by the application of reasonable care and skill*".

This view is acceptable to all. It is also generally accepted that it is no part of the auditor's duty to verify stock through his personal inspection. However, after the decision in **McKesson** and **Robins Case**, physical verification of stock-in-trade is considered to be an important part of auditor's duty. Whatever be the controversy, the fact remains that the auditor should apply test checks and he should physically examine a reasonable part of the stock-in-trade. The quantum and type of test to be applied will depend upon the facts and circumstances of each case.

In the **Block *V.* Klein Case**, the auditors were held guilty of negligence in failing to verify the stock. To conclude, it is always better for an auditor to physically verify the stock.

Verification Procedure

The audit procedure, which the auditor should follow while verifying the stock-in-trade, is as follows:

1. The auditor should examine the internal check system in operation.
2. He should study and make himself familiar with the stock taking system followed in the organisation. He should also see whether the system is proper.
3. He should check the Stock Sheets with the Stock Registers.
4. He should examine how the management controls the receipts and issues of stock.
5. He should check the prices of stock with the help of catalogues, invoices, and price lists
6. He should check the totals, balances, and extensions of stock sheets.
7. He should get a copy of the physical stock taking instructions given by the client before hand and see whether they are proper and possess adequate safeguards against possible errors or frauds.
8. If possible he can send one of his staff to observe the physical stock taking.
9. He should see whether the job of stock sheet preparation is allotted to a responsible official of the organisation and also should insist that a top-level executive like director should sign it.
10. If there is any alteration in stock sheet, he should see whether the responsible official attests such alteration. Besides, he should also find out the intention for such alteration.

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11. He should test check some of the items of the stock with the stock records with regard to their quantity and value. If there is any material difference it must be enquired into.
12. He should test check the physical existence of at least 5% of the items to determine whether records represent correctly the stock in hand.
13. He should see whether all the goods purchased during the year included in the stock.
14. He should see whether all old, and damaged stocks have not been included in the stock, and they have been written off.

Valuation of Stock

Stock in trade is a current asset. It should be valued either at **cost price** or **market price** whichever is lower. Even if the increase in price is of a permanent nature, the stock should be valued at its cost price only. Its market price should not be taken into account. The idea underlying this principle is providing adequately for the anticipated losses.

Cost Price

The term "**Cost Price**" has been interpreted in many ways, which are as follows:

1. **Unit Cost Method:** Under unit cost method, cost of unsold stock will be the actual price at which the lot to which it belongs purchased. If the goods purchased in different lots have been kept separately, the cost of unsold stock can be easily determined.

2. **Average Cost Method:** The principle underlying the average cost method is that the identity of different lots of goods is lost when they received in store. Oil stored in large tanks can be cited as an example here. In such a case, goods in stock are valued at the average cost price of various consignments taken together.

3. **First-in-First Out (FIFO) Method:** The basic assumption under this method is that the goods received first are sold or issued at first. In other words, the goods are issued in the order in which they were purchased. As the goods entered at first are issued at first and the most recent purchases remain in stock at the rate of the latest consignment so purchased. Hence, under this method, stock is valued at the rate at which the most recent purchases were made.

4. **Last-in-First Out (LIFO) Method:** This method is based on the assumption that the goods received at last are sold at first and the unsold stock consists of the earliest purchases and is priced accordingly. In other words, under LIFO method, the stock is valued at the rate at which the earliest purchases were made. However, this method is not much in use for the purpose of valuation.

5. **Base Stock Method:** Under this method, a certain minimum quantity of stock is always carried at the original cost and it is not supposed to be issued unless there is an emergency. This is treated as fixed asset. Materials, which are in excess of base stock, are issued by adopting either FIFO or LIFO principle. The base stock is deemed to have been created out of the first consignment and therefore valued at this price.

6. **Highest-in-First-Out (HIFO) Method:** The HIFO method assumes that the closing stock of materials should always remain at the minimum value, so that issues are priced at the highest value of available consignments in the store. Hence, it understates the value of stock and thus leads to the creation of secret reserves. This method is not popular.

7. **Standard Cost Method:** Under this method, the stock is valued at some predetermined price fixed on the basis of a specification of all the factors affecting the price.

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8. **Adjusted Selling Price Method:** Under this method, an estimated cost is found out by pricing the unsold stock at the prevailing selling price less a normal margin of profits plus the estimated selling expenses including overhead charges.

From the above discussion it is clear that there are so many methods to determine the cost price of the stock. Now the question before us is which method to choose? Our answer to the question is – **"It is the average cost method"**. However, the cost is to be adjusted by adding all the direct expenses incurred on the purchase of goods.

Market Price

The expression market price may be referred to the price of a commodity as agreed between the buyer and the seller. Generally, it is expressed in any of the following ways-

1. Replacement Cost.
2. Net Realisable Value.

The replacement cost is virtually the cost at which the goods can be replaced at the date of the Balance Sheet. It includes the expenses also.

On the other hand, net realisable value means the price at which the goods can be sold in the market. Here the estimated selling expenses are deducted out of the selling expenses.

Out of these two methods, the ICAI, and ICEW suggest that net realisable value method is a true representative of market price. Hence, it can very well be adopted for the purpose.

Methods of Valuation

It is already stated that the stock is ordinarily valued on the basis of cost price or market price whichever is lower. There are two methods available for the purpose. They are as below:

1. **Individual Method or Pick and Choose Method:** Under individual method, in order to calculate the value of stock the cost or market price, whichever is less, of each individual item of stock is taken into account.

2. **Global Method:** Under Global method, the aggregate cost of all the items of stock is taken separately and similarly the aggregate market price is calculated. Then, the lower of the two valuations is taken as the basis for the valuation of stock.

Table 9.2 explains how the valuation is made under these two methods.

Items of Stock (1)	Cost Price (2) Rs.	Market Price (3) Rs.	Lower of the Cost or Market Price (4) Rs.
1.	2,000	3,000	2,000
2.	5,000	4,000	4,000
3.	3,000	3,500	3,000
4.	6,000	5,500	5,500
5.	3,000	3,500	3,000
6.	3,500	4,000	3,500
	22,500	23,500	21,000

TABLE 9.2 – VALUATION OF STOCK

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According to the individual method, the amount shown in Column No. 4 i.e., Rs.21,000 is taken as the value of stock while according to the global method, it is valued at the lowest of the aggregate cost price and that of market price i.e., lowest of Column 2 and Column 3 i.e., at Rs.22,500.

Valuation of Different Kinds of Stock

Stock may be divided into three kinds such as – 1. Raw Materials, 2. Semi-finished Goods, and 3. Finished Goods.

1. **Raw Materials:** Raw materials are purchased for converting the same into finished goods. They are not meant by re-sale. Hence, they are valued at the cost price, which may also include a reasonable amount of expenses incurred in connection therewith. Thus, the market price is not taken into consideration in the valuation of raw materials. But when there is any abnormal fall in the value of raw materials on the day of the Balance Sheet their valuation should be made at below cost.

2. **Semi-finished Goods:** There may be some semi-finished goods in stock on the last day of the accounting year. They are the goods in the process of manufacture i.e., they are partly finished goods. Such goods are valued at cost price including the cost of raw materials used and the proportionate amount of wages, establishment charges, etc.

3. **Manufactured or Finished Goods:** Usually, the stock of finished goods is valued at the cost or market price whichever is lower. But in practice, it is not followed and often, it is valued at cost, at below cost, at market price or at below market price. This all depends upon the circumstances of each and every case. However, if it is not possible to calculate cost or to find out the market price of various items of stock, any of the bases mentioned above is taken for the calculation.

The valuation varies with the type of goods and method of selling. In case of the goods, which have been sold under forward contracts but not delivered at the date of the Balance Sheet, they are valued at contract rates for the purpose of the Balance Sheet. In case of goods sent on consignment the stock of goods with the consignee is valued at cost price plus the proportionate expenses including freight, rent, etc., or market price, whichever is lower. If it is not convenient to find out the market price it is valued at cost price. If the goods have been sent on "**Sale or Return**" basis, they should never be valued at more than the cost price.

There are some special goods like wine, rice, leather, etc., whose value tends to rise with the passage of time. Hence, they are normally valued at above cost. In the value of the stock of these goods, the expenses of maintaining such stocks in safety and interest on them at a reasonable rate are added to the cost. However, under any circumstance, the valuation should not be made at a price, which is higher than the price at which such goods are available in the market. In case of plantation products namely, rubber, tea, sugarcane, coffee, cardamom etc., its stock should be valued at expected selling price less reasonable selling expenses.

Work-In-Progress

The Companies (Amendment) Act, 1960 states specifically that work-in-progress should be shown separately in the Balance Sheet. The auditor should examine all accounts pertaining to the work-in-progress. He should keep in mind the following points while verifying the work-in-progress:

1. If cost accounts are properly maintained in the business, he should check the Statement of Raw Materials used and wages. Otherwise he should prepare a detailed statement to know the progress of work completed.
2. If overhead expenses have been included in the valuation, he should see that they are not excessive.

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3. The basis of valuation and cost of work-in-progress for the current year should be compared with that of the previous year and the difference, if any, should be carefully enquired into.
4. The progress of work should be checked with reference to the time spent and work being done.
5. He should see that creditors' balances are duly provided for. The auditor should obtain the certified Stock Sheets, which contain details about the work-in-progress, work completed, work certified and uncertified, etc., and should check them thoroughly and carefully.

The work-in-progress is normally valued at cost price, which includes the actual cost of materials put into manufacturing process plus some of the labour and other manufacturing expenses. In the calculation of cost price, a reasonable proportion of the profit earned and received to date is also included especially in case of contracts, which extend for a considerable period. **De Paula** suggests the use of standard cost for the valuation of work-in-progress in which the valuation of stock is made on the basis of a pre-determined cost or budgeted cost per unit.

Some other writers are of the opinion that the work-in-progress should be valued at cost price or replacement value whichever is lower.

VERIFICATION AND VALUATION OF LIABILITIES

Verification of liabilities is equally important as that of verification of assets. The Balance Sheet will reveal the true and fair view of the state of affairs of the business concerns only when the liabilities as well as assets are properly valued and verified.

Verification of liabilities aims at ascertaining whether all the liabilities of the business are properly disclosed, valued, classified, and shown in the Balance Sheet. The auditor should see that they are correctly stated in the Balance Sheet. He should obtain a certificate from the responsible official as to the correctness of liabilities. "*The auditor is liable for omission of liabilities from the balance sheet, if such liabilities could be detected by the application of reasonable care and skill*". This was held in the case of **Westminster Road Construction and Engineering Co. Ltd.**

In short, the auditor should have to examine and see that-

1. all the liabilities have been clearly stated in the liability side of the Balance Sheet.
2. they are all relate to the business itself.
3. they are all correct and authorised by the responsible official.
4. they are shown in the Balance Sheet at their actual figures.

We shall now discuss the verification and valuation of various liabilities.

1. Trade Creditors

1. The correctness of liabilities depends upon the correctness of purchases. Hence, the auditor should compare the percentage of gross profits to purchase with that of the previous years to verify the correctness of purchases.
2. The auditor should obtain a Schedule of creditors and verify them with the balances of ledger accounts and statements of account received from creditors.
3. He should check the Purchases Book and Purchases Returns Book with the help of invoices credit notes, etc. He should also check the postings into the Ledger.
4. He should examine the Goods Inward Book to ensure that the goods purchased have been actually received.

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5. He should see that all the purchases made during the year have been accounted for especially at the end of the year.
6. He should examine the discount allowed to creditors during the period and see that these substantiate the credit balances.
7. In case of hire purchases, the auditor should see that the conditions of Hire Purchase Agreement are properly complied with.
8. He should examine the entries made at the beginning as well as at the end of year to check the employees have passed any fictitious entries in this regard.
9. If any debt is found unpaid for a long time, an enquiry should be made since it is possible that instead of paying to the creditor, the amount might have been misappropriated.

2. Bills Payable

In case of bills payable, the auditor should follow the following verification procedure:

1. The auditor should obtain a Schedule of bills payable and its totals should be compared with the Bills Payable Book and Bills Payable Account.
2. The bills paid after the Balance Sheet date should be examined with the entries passed in the Cash Book.
3. The auditor should obtain confirmatory statements from the drawers directly with the permission of his client.
4. He should pay special attention to the bills that have been paid between the date of the Balance Sheet and the date of his audit have been duly written in the books.

3. Loans

1. The auditor should verify the existence of loans, if any. In case of a company he should examine the correspondence, contracts, and Directors' Minute Book.
2. The auditor should ascertain the terms of loan, amount of loan, period and nature of loan, etc. by referring to the loan agreement.
3. He should confirm the balances of the unpaid loans directly from the creditors of the company with the permission of his client.
4. In case of loans or overdrafts taken from a bank, an agreement with the bank and a certificate to that effect should be obtained and examined.
5. The auditor should see whether the interest due has been paid or not. If the interest is due but not paid till the date of the Balance Sheet, he should see whether the same has been clearly shown as liability therein.
6. In case of a Joint Stock Company, the auditor should examine the borrowing powers of the company. He should also examine the Register of Charges, and should see that a charge created has been registered with the Registrar.
7. It should be seen that the interest on loans has been paid up to date. If not he should see whether the amount due is recorded as unpaid in the books of accounts.

4. Outstanding Liabilities for Expenses

1. In case of outstanding liabilities, the auditor should obtain a certificate from a responsible officer of the company stating that all expenses become payable have been brought into account.
2. He should see whether necessary provision for all the outstanding expenses have been made by checking receipts and other vouchers.
3. He should compare the expenses shown as unpaid during the current year with those of the last year and if he finds any difference, the same should be enquired into.

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5. Capital

Capital is not the liability of an entity but still the auditor is required to verify it in order to report the genuineness and correctness of the Balance Sheet.

In case of a firm, the auditor should verify capital with the help of Partnership Deed, Cash Book and the Pass Book. He should see that it has been properly recorded in the books of account.

In the case of a company, verification of capital can be discussed under the two heads:

1) First Audit

In case of first audit, the auditor should examine the Memorandum of Association to see what is the maximum capital, which the company is authorised to raise. He should also check the Articles of Association.

He should examine the Cash Book, Pass Book, and Minute Book of the Board of directors in order to find out the number and the different classes of shares issued, the amount received on each shares, and the balance due from the shareholders in respect of calls, etc.

The shares allotted to vendors, should be examined with the contract between the vendors and the company.

2) Subsequent Audit

Normally, in case of subsequent years, the share capital would be the same as in the previous year unless the company has made any alteration or addition by fresh issue or otherwise. If he come across any change, he should see that the relevant provisions of Secs. 94, 95 and 100 to 105 of the Companies Act have been duly complied with.

6. Reserves and Funds

Reserves and funds are appropriations out of profits. The directors of a company determine the amount of reserves and funds to be created taking into account the circumstances of the business. The reserve and funds are to be shown on the liability side of the Balance Sheet with footnotes.

7. Debentures

1. In case of debentures, the auditor should verify the Memorandum of Association and the Articles of Association of the company and ascertain the power of the company to issue debentures. He should find out what is the borrowing limit and ensure that the company has not exceeded the same.
2. He should verify the Debenture Trust Deed to verify the amount of debentures issued and securities offered. If necessary, he can obtain a certificate from the debenture holders to verify the amount of debentures issued.
3. He should enquire as to what arrangement has been made for the redemption of debentures. In case debenture redemption fund has been created, he should verify the Articles of Association.
4. If the debentures are issued at premium or at discount, the auditor should see that the debenture premium and discount on issue of debenture are properly dealt with in the books of account.
5. He should verify Register of Charges and Register of Debenture Holders to see that the debentures shown in the Balance Sheet agree with the debentures recorded in the books of account.

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8. Income Received in Advance

Sometimes the firm receives some amount in advance, which is to be actually received in the next year. It is treated as a liability and should be shown in the liability side of the Balance Sheet. The auditor should verify whether the items of incomes received in advance are recorded in books. The auditor should obtain a Certified Schedule of income received in advance and verify the same. He should ensure that income received in advance is fully shown in the liability side of the Balance Sheet.

9. Employees' Deposits

In commercial and industrial establishments, it is usual to require the employees who deal with cash or stores to give security deposit. It acts as a safeguard against some possible misappropriation or pilferage on the part of such employees. Sometimes, the employees instead of paying cash as security deposit endorse trustee securities in favour of the employers. In such cases, the auditor should see whether such a security in cash or in securities deposited separately in the bank. He should see whether they are shown distinctly in the liabilities side of the Balance Sheet. He should verify the amount of deposits by reference to the Certified Schedule received from the client.

10. Taxation Liability

Now-a-days, taxation has become an important liability and so the companies are required to make full provision in the accounts in this regard. The auditor should see whether the provision made therefor is sufficient to meet the estimated liability. Usually, auditors are required to advise on the adequacy of the liability and in such a case, they work as tax consultant.

CONTINGENT LIABILITIES

Contingent liabilities are those liabilities, which may or may not arise in the future for payment. The auditor's duty is to see that all known and unknown liabilities have been brought into the accounts at the date of the Balance Sheet and have been shown in the Balance Sheet separately as such. Some of the instances of contingent liability and auditor's duty as regards to those instances are discussed hereunder:

1. **Bills Receivable Discounted but not Matured:** In case of bills receivable discounted with a bank but not matured at the date of the Balance Sheet as the money received by way of discounting from the bank is made use of, the entire money is to be refunded to the bank if the acceptor does not make payment on the date of its maturity. This is why such a contingent liability is referred to be shown distinctly in the Balance Sheet by way of a foot note.

2. **Calls on Partly Paid up Shares:** The amount called up on shares held and paid should be verified from the Cash Book and the liability for the amount uncalled should be ascertained.

3. **Guarantee:** The auditor should ascertain the liability for a guarantee if any, given by the client for a loan or overdraft to his friend, or partner. If any such loan is not repaid, he should ascertain, the possible liability.

4. **Cases against the Company not Acknowledged as Debts:** It refers to a liability, which arise in a disputed case where d nages may have to be paid. In such a case, the contingent liability should be ascertained and a note should be made at the foot of the Balance Sheet.

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5. **Penalties under Forward Contracts:** The auditor should assess the possibilities of losses in case of purchases or sales made under forward contracts and see whether proper provision has been made for such losses.

6. **Arrears of Dividend on Cumulative Preference Shares:** The auditor should examine the Articles of Association, which contains rules regarding the arrears of dividend on cumulative preference shares and due provision should be made for such a liability.

REVIEW QUESTIONS

Part - A

1. Define the term verification.
2. What is the purpose of valuation?
3. What are fictitious assets?
4. What are the functions of verification?
5. What are current assets?
6. What are wasting assets?
7. What is cost price?
8. What is contingent liability?
9. What is market value?
10. What are the different methods of valuing stock?
11. What is HIFO?
12. What is LIFO?

Part - B

1. Distinguish between verification and vouching.
2. What are the objectives of verification of assets and liabilities?
3. Briefly explain as to how an auditor verifies cash in hand.
4. How would you verify trade marks?
5. Briefly explain the different methods of valuation of stock.
6. How would you verify trade creditors?
7. Discuss the auditor's duty regarding verification and valuation of assets.
8. Briefly explain the valuation of different kinds of assets.

Part - C

1. What do you mean by verification? Distinguish between verification and valuation.
2. Define the term verification. Distinguish clearly between vouching, verification and valuation.
3. "*An auditor is not a valuer*". "*An auditor is intimately connected with values*". Explain fully how these two statements can be reconciled.
4. How would you verify the following: 1. Goodwill, 2. Freehold Property, 3. Motor Vehicles, 4. Trade Marks, and 5. Cash-in-hand.
5. How would you verify the following assets and liabilities appearing in the Balance Sheet of a Limited Company? 1) Investments, 2) Copyrights, 3) Patents, 4) Outstanding Liabilities for Expenses, and 5) Bills Payable.
6. What is the general procedure of valuing and verifying the stock-in-trade? How far an auditor is responsible for verification of stock-in-trade?
7. What are the contingent liabilities? Give five examples of such liabilities. What is the method by which you would satisfy yourself at the time of audit that all contingent and outstanding liabilities have been disclosed in the Balance Sheet?
8. Explain clearly the duties of an auditor regarding the valuation of various assets appearing in the Balance Sheet of a manufacturing company.

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DEPRECIATION

10
CHAPTER

Introduction - Meaning and Definition of Depreciation - Change in Method of Depreciation - Disclosures - Auditor's Duty.

INTRODUCTION

The term "**Depreciation**" has been derived from a Latin word "**Depretium**", which means decrease in the value of fixed assets. The assets decrease in this way due to natural wear and tear or efflux of time. It refers to the gradual diminution, loss or shrinkage in the utility value of an asset on account of wear and tear in use, efflux of time or obsolescence.

Depreciation accounting aims at distributing the cost of basic value of tangible capital assets, less salvage over the estimated useful life of the assets in a systematic and rational manner. Depreciation is no way connected with fluctuation, which is due to external causes. On the other hand, depreciation is connected with internal causes.

MEANING AND DEFINITION OF DEPRECIATION

The cost of fixed assets is nothing but the price paid for a series of future services. Hence, it is essential that the cost of the fixed assets be spread over a number of years during which benefit of the assets is derived. This process of spreading the cost of fixed asset over its useful life is termed as depreciation. Thus, depreciation is an expense in each of the accounting periods in which the asset provides service to the enterprise. It is an expense just like the expenses incurred on rent, salaries, fire insurance premium, and carriage. Depreciation is the cost of usefulness lost or the cost of diminution of service yield from a fixed asset. It has been defined in the AS 6 in the following words:

"*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. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined*".

Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. It is charged in each accounting year by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

The assessment of depreciation as well as the amount to be charged in respect thereof in an accounting period are usually done on the basis of the following three factors:

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1. Historical cost of the asset. However, where the asset has been revalued, the amount substituted for the historical cost of the depreciable asset will be considered for the purpose.
2. Expected useful life of the depreciable asset.
3. Estimated residual value of the depreciable asset.

Depreciable Assets

AS 6 states that "*Depreciable assets are assets which*

(i) are expected to be used during more than one accounting period; and

(ii) have a limited useful life; and

(iii) are held by an enterprise for use in the production or supply of good and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business".

Useful Life

As defined by AS 6, "*Useful life is either*

(i) the period over which a depreciable asset is expected to be used by the enterprise; or

(ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise".

The useful life of a depreciable asset is shorter than its physical life and is:

(i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
(ii) directly governed by extraction or consumption;
(iii) dependent of the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
(iv) reduced by obsolescence arising from such factors as:
  (a) technological changes;
  (b) improvement in production methods;
  (c) change in market demand for the product or service output of the asset; or
  (d) legal or other restrictions.

Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

Need for Providing Depreciation

Provision for depreciation is necessary on the following grounds:

1. Depreciation refers to the cost of the fixed asset used up in the period. This must be treated as cost or expense and debited to the Profit and Loss Account; otherwise the profit will not be correctly assessed.
2. If the fixed assets are shown continuously at their original worth in the Balance Sheet it will over estimate the value of the assets possessed by the firm when really, due to wear and tear and efflux of time, the value of the assets is much less. Therefore, depreciation, must be accounted for in order to show the assets at their proper value.

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3. The amounts debited in the Profit and Loss Account are retained in the business because like other expenses, here no payment is actually made. These can be used for replacement of the asset when its life is over.
4. The real idea behind the provision of depreciation on a particular asset is to keep the capital intact and show the correct value of the asset in the Balance Sheet. Hence, the entire loss is distributed over a number of years for which the asset remains in use.
5. Every asset is purchased in a business for use and its constant use causes depreciation or decrease in its earning capacity. Such a decrease in value is like any other business expense, which must be debited to Profit and Loss Account. If it is not done, correct profits cannot be calculated. Further, when the asset will become a mere scrap, it would be a heavy charge on the Profit and Loss Account if the whole of the loss, is charged to the Profit and Loss Account of that year. This is totally unfair, unjustified and against business principles.

Nature of Depreciation

Depreciation is an illustration of an expense. The using up or consumption of an asset in the normal course of business has usually been written off by way of depreciation. Depreciation is not the process of valuation of asset. Only the used up portion of assets is calculated and allocated to its estimated life time. Thus, it is a process of allocation of cost of the asset to the period of its life. It is calculated on the actual cost of an asset under "**Conventional Accounting System**" or "**Historical Accounting Method**". Neither replaced value nor current costs are taken into consideration for providing depreciation. Depreciation is not accumulated separately. Accumulating cash resources (by depreciation fund method, Insurance policy method) is only a financial procedure for ensuring its depreciation. Maintenance of assets in a state of efficiency is not a substitute for the depreciation provision.

Depreciation measures the amount by which the value of an asset falls through time. This depends partly on how well the asset is maintained whether the buildings are painted regularly, whether leaks in the boilers are fixed at once, whether broken parts are immediately replaced and so on. The cost of maintenance repairs is not usually included in depreciation. The cost of keeping the asset, "**In a good State of Repair**" is usually calculated separately, and treated as an operating expense on the same footing as wages and raw materials. Depreciation therefore measures the extent to which the value of the asset has deteriorated although it is being kept in a good state of repair.

Assets, which are more or less constantly in use, naturally diminish in value due to their wear and tear in the business. Expenditure on acquiring such assets, which will be held over several years with the object of earning revenue is treated as capital expenditure, such expenditure includes the price paid and the installing cost.

Professor **Bonbright** in his book, "**Valuation of Property**", points out that substantially all the different technical meanings attached to the word "**Depreciation**" are variants of four basic concepts. They are:

1. Decrease in value.
2. Amortized cost.
3. Difference in value between an existing old assets and hypothetical new asset taken as a standard for comparison.
4. Impaired serviceableness.

Depreciation in the popular sense of decrease in value may refer either to decrease in market value or to decrease in value to the owner.

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In the accounting sense of amortization of cost, depreciation does not refer either to market value or to value to the owner. It is cost, not value, that is being written off by the accountant where the phrase "**Book Value**" is used to mean unamortized cost as shown by the books of account, the word "**Value**" is used in its natural sense as any money amount that is associated with specific property units.

In the appraisal sense of difference in value between an existing old asset and a hypothetical new asset taken as a standard of comparison, depreciation appropriately refers only to the concept of value to the owner. Where depreciation in this is calculated by a prospective owner as a basis for a bid, the acceptance of this bid would make the actual market price the same as the calculated value to the owner. However, the estimate of the value inferiority of an existing old asset as compared to the most economical substitute asset has no meaning except with regard to a specific service to be performed for a specific owner.

Impaired serviceableness may result in decrease in value, but there are many other reasons for such a decrease.

The value of a fixed asset depreciates though less even if the asset is not in use. "One writer has therefore, defined it as "*Gradual diminution, loss or shrinkage in the utility value of an asset due to wear and tear in use, efflux of time or obsolescence*". The same view has again been supported by **B.G. Vickery**. He defines it as "*A permanent decrease in the value of an asset through wear and tear in use, or passage of time*".

According to **Cropper, Maris** and **Fission** the decrease in value of an asset is mainly due to constant use of an asset in the business. They said, "*Depreciation is a term employed by accountants to indicate the gradual deterioration both in the value and the usefulness of these assets which, by reason of their nature and uses steadily decline in value*".

De Paul says "*In practice, the term "**Depreciation**" is commonly used in a very wide sense, covering diminution in the value of assets caused by outside fluctuations in realisable and replacement values, and also the amortization in the cost of an asset over the period of its use*". This kind of loss arising on account of new inventions which have come into the market and the use of which will make the goods cheaper, better and in larger quantity. This is what is called obsolescence.

It must be remembered that depreciation as used in accountancy is not the same thing as physical depreciation. According to **Montgomery**, "*Plant and equipment is generally understood to be the loss in useful life or efficiency caused by wear and tear from operation and by deterioration, resulting from chemical reactions from air, water, gas or other elements. Invarying degrees it takes place whether plant and equipment is operated or is idle; whether it is well cared for or neglected. Whether it is built from materials of good quality or constructed from scrap*".

The Institute of Chartered Accountants in Australia says, "*Depreciation represents that part of the cost of a fixed asset to its owner which is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit cleared*".

Significance of Depreciation

It has been aptly said, "*All machinery is on an irresistible march to the junk heap*". Even before assets reach the junk heap, their values decrease. Experience indicates that this is a true statement. The problems created by this fact are becoming increasingly important to business and

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Government. This is because, "*nearly all business decisions called for by the decline in value of assets relate in some way to the conservation of invested capital*".

No dividend shall be declared or paid except out of profits of the company arrived at after providing for depreciation. Hence, profits may be sufficient or insufficient, or dividend may be satisfied or not, but depreciation must be provided for. Thus, it plays an important role in the calculation and the distribution of profit.

Depreciation enables the company to restate the value of assets in its real sense in the Balance Sheet. Thus it gives the true and fair view of accounts.

As it is stated earlier, depreciation reduces the profit-before-depreciation figure and this saves the cash resources of the concern (to the extent of Depreciation) from being distributed by way of dividend. The amount so saved, on the one hand, if set aside every year, is able to produce, at the end of the life of the asset, the amount required to replace it. On the other hand, as depreciation is one of deductions allowed before computing the profits and gains of business or profession, the tax payer need not pay any tax on it.

Depreciation plays an important role in pricing the product. "*In modern cost terminology, overhead charges include all indirect cost, indirect material cost, indirect expenses and the depreciation of fixed assets which cannot be identified as direct cost of a cost center or cost unit*".

For analysing the investment in securities, care must be taken in view of depreciation. The investment analyst cannot safely ignore the consideration of depreciation in his study of either the Profit and Loss Statement or the Balance Sheet. A downward revaluation of assets may actually make the business seem to be more valuable than before. The resulting smaller annual depreciation charge increases the apparent profits. For these and other reasons depreciation calls for a particularly careful consideration in investment analysis.

Methods of Providing Depreciation

There are several methods of allocating depreciation over the useful life of the assets. Of them the most commonly employed methods in industrial and commercial enterprises are the straight line method and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors such as- 1. type of asset, 2. the nature of the use of such asset, and 3. circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets, which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.

The following are the various methods for providing depreciation:

1. Straight Line or Fixed Percentage on Original Cost or Fixed Instalment Method.
2. Written Down Value or Fixed Percentage on Diminishing Balance or Reducing Instalment Method.
3. Annuity Method.
4. Depreciation Fund Method.
5. Insurance Policy Method.
6. Sum of the Digits Method.
7. Revaluation Method.
8. Depletion Method.
9. Machine Hour Rate Method.
10. Repairs Provision Method.

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1. Straight Line Method

Under this method, a fixed percentage of original cost is written off the asset every year. Thus, if an asset costs Rs.20,000 and 10 per cent depreciation were considered adequate, Rs.2,000 would be written off every year. The amount to be written off every year is arrived at as under:

$$= \frac{\text{Cost minus Estimated Scrap Value}}{\text{Estimated Life}}$$

The period for which the asset is used in a particular year should also be taken into account. This method is simple in calculation and also in such a case, the charge to the Profit and Loss Account is uniform every year. This method is useful when the service rendered by the asset is uniform from year to year. It is desirable, when this method is in use, to estimate the amount to be spent by way of repairs during the whole life of the asset and provide for repairs each year at the average actual repairs.

2. Written Down Value Method

Under this method, the rate or percentage of depreciation is fixed, but it applies to the value at which the asset stands in the books in the beginning of the year. In other words, under this method, a fixed percentage is written off every year on the reduced balance of the asset. Thus, the percentage of depreciation is not applied to the original cost but only to the balance, which remains after charging depreciation in the beginning of a year. The percentage of depreciation remains fixed for all the years of the working life of an asset but the actual amount of depreciation written off every year goes on decreasing with the reduction in the value of the asset.

3. Annuity Method

The annuity method takes into account the interest lost on the acquisition of an asset. Interest is calculated on the book value of the asset at the current rate and debited to the asset account and credited to interest account. The amount to be written off as depreciation is calculated from the annuity tables. The depreciation will be different according to the rate of interest and according to the period over which the asset is to be written off. Annuity method is much suited to those assets that require considerable investment and where frequent additions are not made. It is not suited for plant and machinery where additions are usually made quite often.

4. Depreciation Fund Method

Under this method, the amount of depreciation goes on accumulating till the asset is completely worn out. This amount becomes readily available for the replacement of the asset. The amount of depreciation is fixed and remains the same year after year and is charged to Profit and Loss Account every year through the creation of Depreciation Fund. It is otherwise known as Sinking Fund. The amount of annual depreciation is invested outside the business every year in good securities bearing interest at a specified rate. The process of investing the amount of depreciation together with interest received goes on till the time of replacement of asset. At this time, all the securities are sold out and with cash received, the new asset is purchased. This method enables a firm to purchase very costly assets without any difficulty in arranging cash resources.

5. Insurance Policy Method or Capital Redemption Policy Method

Under this method the business takes a policy from an insurance company. The amount of the policy is such that it is sufficient to replace the asset when it is worn out. Cash, which is equal to

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the amount of depreciation, is paid by way of premium every year. The amount goes on accumulating with the insurance company at a certain rate of interest and is paid back to the insured at the maturity of the policy. The amount so made available by the insurance company is used for purchasing a new asset. This method to a great extent is similar to sinking fund method, but no doubt the procedure is a little different. In this method, instead of buying securities, the insurance policy is taken and premium is paid every year. Company, receiving premium, allows a small rate of interest on compound basis.

This method is a more suitable device for ensuring the availability of cash to replace the asset. The advantage under this system is that the company need not worry whether the investments as under the Depreciation Fund Method, will be sold at best prices or not. If an insurance policy is taken, it serves two purposes. Firstly, it insures the asset. Secondly, the insurance company will pay the stipulated amount to enable the company to replace assets. This method is more expensive as the insurance company has to keep its margin of profits. It is suitable for losses where the life of the asset is definitely known. It yields a very low rate of interest. It makes no adjustments for price-level changes.

6. Sum of the Digits Method

Under this method, amount of the depreciation to be written off each year is calculated by the following formula:

$$= \frac{\text{Remaining Life of the Asset (including the Current Year)}}{\text{Sum of all the Digits of the Life of the Asset in Years}} \times \text{Cost of the Asset}$$

Suppose the life of an asset costing Rs.50,000 is 10 years. The sum of all the digits from 1 to 10 comes to 55 i.e., 10+9+8+7+6+5+4+3+2+1 = 55. The depreciation to be provided in the first year will be:

$$= \frac{10}{55} \times 50{,}000 \text{ or Rs.9,091}$$

In the second year, it will be:

$$= \frac{9}{55} \times 50{,}000 \text{ or Rs.8,181}$$

This method is similar to the Written Down Value Method described earlier.

7. Revaluation Method

This method is used only in case of small items like cattle (Livestock), or loose tools where it may be too much to maintain an account of each single item. The amount of depreciation to be written off is determined by comparing the value at the end of the year (valuation being done by some one having expert knowledge of the valuation of the asset) with the value in the beginning. Suppose on 1st April 2,007 the value of loose tools was Rs.10,000 and during the year Rs.30,000 worth of tools were purchased. Now if at the end of the year, the loose tools are considered to be worth only Rs.25,000 the depreciation comes to Rs.15,000 i.e. Rs.10,000 + Rs.30,000 – Rs.25,000.

8. Depletion Method

This method is used in case of mines, quarries, etc., where an estimate of total quantity of output likely to be available should be available. Depreciation is calculated per ton of output. For

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example, if a mine is purchased for Rs.20,00,000 and it is estimated that the total quantity of mineral in the mine is 5,00,000 ton, the depreciation per ton of output comes to-

$$= \frac{20,00,000}{5,00,000} = \text{Rs.4.}$$

If the output in the first year is 30,000 then the depreciation will be 30,000 x Rs.4 = Rs.1,20,000, in the second year, the output may be 50,000 ton; the depreciation to be written off will be Rs.2,00,000 i.e., 50,000 x Rs.4.

9. Machine Hour Rate Method

This is more or less like the depreciation method. Instead of the usual method of estimating the life of a machine in years, it is estimated in hours. Then, an accurate record is kept recording the number of hours each machine is run and depreciation is calculated accordingly. For example, the effective life of a machine may be 30,000 hours. If the cost of the machine is Rs.4,50,000, the hourly depreciation is-

$$= \frac{4,50,000}{30,000} = \text{Rs.15.}$$

The depreciation for a particular year during which the machine runs for 2,500 hours will be 2,500 x Rs.15 = Rs.37,500.

10. Repairs Provision Method

The Institute of Cost and Management Accountants of England and Wales has defined this method as follows: "*The method of providing for the aggregate of depreciation and maintenance cost by means of periodic charges each of which is a constant proportion of the aggregate of the cost of the asset depreciated and the expected maintenance cost during its life*". It means that to the cost of the asset (less its estimated scrap value), the amount expected to be spent on its repairs and maintenance throughout its life should be added and the sum be divided by its estimated life.

CHANGE IN METHOD OF DEPRECIATION

AS 6 states that the depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it were considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective re-computation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

DISCLOSURES

AS 6 states the following about the disclosures to be made in the financial statement regarding depreciation:

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1. The depreciation methods used, the total depreciation for the period for each class of assets, the gross amount of each class of depreciable assets and the related accumulated depreciation should be disclosed in the financial statements along with the disclosure of other accounting policies. The depreciation rates or the useful lives of the assets should be disclosed only if they are different from the principal rate specified in the statute governing the enterprise.
2. In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect of the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.
3. A change in the method of depreciation is treated as a change in an accounting policy and it should be disclosed accordingly.

Statutory Provisions Regarding Depreciation under the Companies Act, 1950

Sections 205, 349(4)(k), and 350 deal with depreciation. Sec. 349, which deals with determination of net profits, says in computing the net profits of a company in any financial year, depreciation to the extent specified in Sec. 350 should be deducted. If we look at Sec. 350, it states that the amount of depreciation to be deducted in pursuance of clause (k) of sub-section (4) of section 349 shall be the amount of depreciation on assets as shown by the books of the company at the end of the financial year expiring at the commencement of this Act or immediately thereafter and at the end of each subsequent financial year at the rate specified in Schedule XIV.

However, if any asset is sold, discarded, demolished or destroyed for any reason before depreciation of such asset has been provided for in full, the excess, if any, of the written down value of such asset over its sale proceeds or, as the case may be, its scrap value, shall be written off in the financial year in which the asset is sold, discarded, demolished or destroyed.

Sec. 205(1) of the Act states that no dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with those provisions and remaining undistributed or out of both or out of moneys provided by the Central Government for the payment of dividend in pursuance of a guarantee given by that government.

However if the company has not provided for depreciation for any previous financial year or years which falls or fall after the commencement of the Companies (Amendment) Act, 1960 (65 of 1960) it shall, before declaring or paying dividend for any financial year provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial year or years.

Further Sec. 205 (2) states that depreciation shall be provided either-

(a) to the extent specified in section 350; or
(b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five per cent of the original cost thereof to the company by the specified period in respect of such asset; or
(c) on any other basis approved by the Central Government which has the effect of writing off by why of depreciation ninety-five per cent of the original cost to the company of each such depreciable asset on the expiry of the specified period; or

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(d) as regards any other depreciable asset for which no rate of depreciation has been laid down by this Act or any rules made there under, on such basis as may be approved by the Central Government by any general order published in the Official Gazette or by any special order in any particular case.

However, where depreciation is provided for in the manner laid down in clause (b) or clause (c), above then, in the event of the depreciable asset being sold, discarded, demolished or destroyed the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the proviso to section 350.

Besides Schedule XIV to Act gives the rate of depreciation for various assets. The Notes given in Schedule XIV states the following points for our consideration:

1. During any financial year, where any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a pro rata basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed.
2. The following information should also be disclosed in the accounts:
   (i) depreciation methods used; and
   (ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in tne Schedule.
3. The calculations of the extra depreciation for double shift working and for triple shift working shall be 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. For this purpose, the normal number of working days during the year shall be deemed to be-
   (a) in the case of a seasonal factory or concern, the number of days on which the factory or concern actually worked during the year or 180 days, whichever is greater;
   (b) in any other case, the number of days on which the factory or concern actually worked during the year or 240 days, whichever is greater.
4. The extra shift depreciation shall not be charged in respect of any item of machinery or plant which has been specifically, excepted by inscription of the letters "**N.E.S.D**". (meaning "**No Extra Shift Depreciation**") against it in sub-items above and also in respect of the items of machinery and plant to which the general rate of depreciation of 13.91 per cent applies.
5. In case of assets whose actual cost does not exceed five thousand rupees, shall be provided depreciation at the rate of hundred per cent. However, where the aggregate actual cost of individual items of plant and machinery costing Rs.5,000, or less constitutes more than 10 per cent of the total actual cost of plant and machinery, rates of depreciation applicable to such items shall be the rates as specified in Item II of the Schedule.

AUDITOR'S DUTY

The auditor's duty in case of depreciation is summarised below:

1. It is the duty of the auditor to ensure that depreciation is provided adequately and the depreciation charged is properly disclosed in the Profit and Loss Account and the Balance Sheet. If the auditor is not satisfied on the above, he should report the same.
2. The auditor should see whether relevant principles of accountancy have been followed in making provision for depreciation.

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3. He should see whether the officers of the business have sincerely and honestly made provision for depreciation.
4. He should check whether the principles followed from year to year for providing depreciation are more or less the same.
5. The auditor should examine as to whether the capital employed in the assets is being kept intact.
6. He should see whether the business traditions and rules have been fully considered
7. He should see whether the provisions of Companies Act as regards depreciation have been duly complied with.
8. He should see whether all the disclosures as required by AS 6 and the Companies Act have been duly made in the financial statements.

But if he finds that:

1. the depreciation has not been dealt with honestly by the management.
2. competent persons have not been employed, and if employed they have not carefully examined the issue.
3. the provision for depreciation is not adequate.
4. the principles of accountancy have not been followed by the management in making the charge for depreciation.
5. the disclosures as required by AS 6 as well as the Companies Act have not been made.

the auditor should draw the attention of the owners of the business towards the issue and mention the fact in his report. If there is any change in the method of providing for depreciation, it must be disclosed in the Profit and Loss Account along with its effect on the profit or loss for the year.

REVIEW QUESTIONS

Part - A

1. Define the term depreciation.
2. What are depreciable assets?
3. What do you mean by useful life?
4. What are the different methods of depreciation?
5. What do you mean by straight line method?
6. What do you mean by written down value method?

Part - B

1. What is the need for depreciation?
2. Explain briefly the various methods of depreciation?
3. Whether method of depreciation can be changed frequently?
4. What are the disclosures to be made in the financial statements of a company as per AS 6?

Part - C

1. Define the term depreciation. Why it is needed? Discuss the statutory provisions regarding the provision of depreciation.
2. Explain briefly the various methods of depreciation.
3. Discuss the nature, importance and need for providing depreciation.

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RESERVES & PROVISIONS

11 CHAPTER

Introduction - Meaning and Definition of Reserve - Characteristics of Reserve - Classification of Reserves - Provision: Characteristics of Provision - Purpose of Creating Provision - Difference between Reserves and Provision - Auditor's Duty.

I. RESERVES

INTRODUCTION

Reserve is the amount set aside out of undistributed profits and other surpluses. It consists of transfers from the Profit and Loss Appropriation Account to add to the working capital of the company and for strengthening the financial position of the business. It is not designed to meet any liability or contingency known to exist at the date of the Balance Sheet.

MEANING AND DEFINITION OF RESERVE

Reserve may be referred to an amount, which is set aside out of the profits of a business for any kind of known and unknown contingency, liability and diminishing value of assets. It is an appropriation of profits before declaration of dividend and not a charge on profit. It denotes that part of profits, which is retained in the business. In other words it consists of profits or surplus assets, which are not distributable. Reserve is kept aside for emergency likely to arise in the future. Any known or unknown contingency, when arises, can be met out of reserves so created.

According to Part III of Schedule VI to the Companies Act 1956, "*The expression "**Reserve**" shall not subject as aforesaid include any amount written off or retained by way of providing for deprecation, renewals or diminution in value of assets or retained by way of providing for any known liability*".

According to the **American Institute of Accountants**, "*The use of the term "Reserve" be limited to indicate that an undivided portion of the assets is being held or retained for general or specific purpose*".

It is clear from the above definitions and explanations that reserve is an appropriation against Profit and Loss Account with a view to meet general contingencies or specific purposes.

CHARACTERISTICS OF RESERVE

The basic characteristics of reserve are as follows:

1. The reserve is an appropriation of divisible profit.
2. It is provided to meet known and unknown future contingencies or unexpected loss.
3. Reserve is not a charge against profit.

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4. It serves as additional fund for working capital.
5. The creation of reserve is not compulsory except in the case of banking business and joint stock companies.

CLASSIFICATION OF RESERVES

Reserves are classified into six types as shown is Fig. 11.1. A brief explanation of these types of reserves is as follows:

1. General Reserve

A general reserve is a reserve, which is created by appropriation of profits. It is created without any specific or particular purpose. The aim of creating a general reserve is to provide additional working capital or to strengthen the cash resources of the business, out of profits of the company, from Profit and Loss Appropriation Account. They may be utilised for meeting any unknown liability. It is also called **"Free Reserve"**. According to the Companies Act, general reserve is to be created only when there is sufficient profit in an enterprise. Hence it is clear that it is not compulsory to create general reserve. However, if the Articles of Association lay down that a specific amount is to be set aside out of profit before the distribution of dividend then the amount should be transferred to General Reserve Account. General Reserve Account will be shown on the liability side of the Balance Sheet.

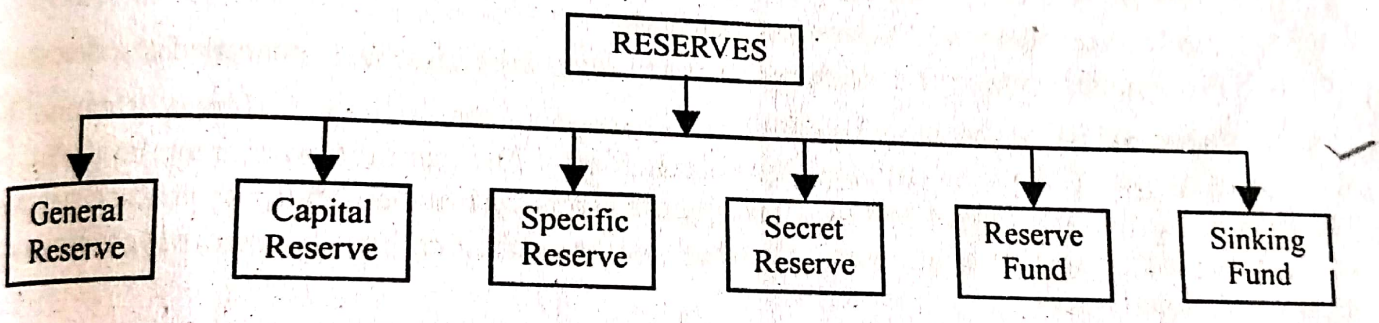


FIG. 11.1 – CLASSIFICATION OF RESERVES

Objects of Creating General Reserves

Following are the objects of creating general reserves in an entity:

1. Strengthening the liquid resources of a business.
2. Making available additional working capital for the firm.
3. Meeting any known liability, contingency or similar other commitment.
4. Equalising the rate of dividend in the years in which profits are inadequate. However it will be used for the purpose only when separate dividend equalisation reserve is not created.
5. Concealing actual profits in the years in which profits are excessive so as to use them to maintain dividend rate in those years in which profits are inadequate.

Auditor's Duty

The question of creating a general reserve depends absolutely upon the policy of the management. The auditor has nothing to do with it. He can neither make recommendations in this connection nor can place any restrictions on this account. He should simply see that a general reserve is created in the interests of the business and shown properly in the Balance Sheet. He should keep the following points in mind while verifying the general reserve:

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1. The auditor should ensure that the general reserve is created for the best interest of business.
2. He should see that company's Articles of Association provide for the creation of general reserve. He should also see whether the provision regarding the creation of general reserve made in the Articles has been complied with.
3. He should see that the general reserve is created out of profit, which is real as shown in the Balance Sheet.
4. Where any part of general reserve is utilised for the payment of dividend, he should ensure that the amount drawn for the purpose is separately shown.
5. Where the general reserve is invested in outside securities, it is the duty of the auditor to see that such investments are shown on the asset side of the Balance Sheet.

2. Capital Reserve

The term capital reserve does not include any amount regarded as free for distribution through the Profit and Loss Account. A capital reserve is generally created out of profits or gains of a capital nature which include the following:

1. Profit on reissue of forfeited shares.
2. Profit on sale of fixed assets.
3. Premium on issue of shares or debentures.
4. Profit prior to incorporation.
5. Profit on revaluation of assets and liabilities.
6. Profit on redemption of debentures. It arises when debentures are redeemed at a discount.

All these profits are not earned in the regular course of the business. Hence, it cannot be distributed by way of dividend amongst the shareholders. The capital profits may, however, be utilised either for the purpose of writing off intangible assets such as goodwill, copyrights, patents, etc., or preliminary expenses or discount on issue of shares or debentures or underwriting commission or to meet capital losses.

Capital Reserve and Reserve Capital are not the same. They are different from each other. Reserve Capital is that part of the company's uncalled capital, which has to be called up only in the event of winding up of a company. The company can provide for this by special resolution. Such a conversion of equity capital into reserve capital is useful to third parties, as in the event of winding up of a company they are at least assured of getting this amount.

Auditor's Duty

1. The auditor should see that a capital reserve is created out of capital profit only.
2. He should ensure that capital reserve is utilised for meeting losses of capital nature.
3. In case capital reserve is used for distribution among the shareholders by way of dividend, he should examine the rules given in the Articles of Association and Law.
4. The auditor should see whether it is shown separately in the Balance Sheet and distinguished from the revenue or general reserve.
5. He should verify whether it is invested outside securities or retained in the business.

3. Specific Reserve

A specific reserve is one, which is created for some specific purpose by debiting Profit and Loss Appropriation Account. Normally, it is available for the purpose for which .. has been created. Some of the examples of specific reserves are as below:

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1. Dividend Equalisation Reserve.
2. Investment Fluctuation Reserve.
3. Debenture Redemption Reserve.
4. Plant and Machinery Replacement such as Sinking Fund Reserve or Depreciation Fund Reserve.

However, sometimes, at the discretion of the Board of Directors in a company, a specific reserve may be utilised for a purpose other than one of its creation, e.g., Investment Fluctuation Reserve may be utilised by the Board, after passing the necessary resolution, in paying dividends to shareholders.

Objects of Creating Specific Reserve

Generally, the specific reserve is created with the following objectives:

1. To meet out outstanding liabilities for expenses due.
2. To write off loss arising out of depreciation or diminution in assets such as depreciation reserve.
3. To meet specific contingency such as provision for bad and doubtful debts, provision for discount, and provision for fluctuation in the investment.

Auditor's Duty

In case of specific reserve, the auditor should follow the following procedure:

1. Auditor should verify the objective with which provisions have been made.
2. He should see that the provision made is adequate to meet the objective.
3. If the provision made is not adequate he should ask the management to do the needful to increase it; otherwise he should disclose the same in his audit report.
4. He should see whether the provisions are properly shown on the liability side of the Balance Sheet.
5. In case specific reserve holds any other purpose other than the one for which it is created, the auditor should see that the Board has authorised it properly.

Secret Reserve

The term secret reserve refers to a reserve the existence of which does not appear on the face of the Balance Sheet. This is also called "**Hidden Reserve**" or "**Internal Reserve**". Such a reserve is not disclosed on the Balance Sheet. It can be said that there is a surplus of assets over liabilities and that surplus is not disclosed or shown by the Balance Sheet.

The joint stock company's Balance Sheet and Profit and Loss Account must exhibit a true and fair view of the financial position of the company. Any method for creation of secret reserve would defeat the provisions of section 211 of the Companies Act. Hence, as per the provisions of the Companies Act a joint stock company is prohibited to create secret reserves but in the case of financial companies like the banking companies, insurance companies, and electricity supply companies have the provisions to create secret reserve. These companies are exempted from the provisions of the Schedule VI to the Companies Act.

Hence, mostly all banks and finance companies create secret reserves with a view to equalise dividends or to provide a fund out of which heavy losses can be met, without disclosing the fact to the shareholders and the general public. The effect of secret reserve is to maintain the confidence

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of the customers and creditors by giving the impression of stability to a prosperous but fluctuating business, to check speculation in its shares and avoid disclosing information to competitors. There is, however, no doubt about the fact that where a secret reserve exists, the Balance Sheet of the business will not reveal the correct view of the financial affairs of the business.

Method of Creation of Secret Reserves

Secret reserves may be created in the following ways:

1. Providing excess depreciation on fixed assets such as plant, machinery, land & building, furniture and fixtures, etc.
2. Writing down an asset completely.
3. Understating goodwill.
4. Undervaluing assets such as stock, investments, etc. and showing them much below their cost or market value.
5. Non-recording of permanent rise or appreciation in value of a fixed asset, e.g., buildings.
6. Providing excessively for bad and doubtful debts.
7. Overvaluing liabilities.
8. Including of fictitious liabilities.
9. Showing contingent liabilities as real liabilities.
10. Charging capital expenditure to revenue or crediting revenue receipts to an asset account.
11. Suppression of accrued incomes and prepaid expenses.
12. Making excess provision for expenses.

Objects of Creating Secret Reserve

The inherent ideas of creating secret reserve are as follows:

1. Maintaining a strong financial position.
2. Improving the solvency position of the entity.
3. Meeting sudden future financial losses.
4. Facing competitions.
5. Confusing the rivals regarding profitability.
6. Providing additional working capital.
7. Maintaining a stable dividend payment.
8. Hiding a portion of profit.
9. Enabling the directors to tide over unfavourable time.
10. Helping the management not to distribute the hide portion of profit, which is retained in the business in the form of secret reserve to the shareholders in the interest of the business.

Auditor's Duty

While verifying the secret reserve, the auditor should keep the following points in mind:

1. He should enquire and find out what is the necessity of creating a secret reserve.
2. He should study thoroughly the Articles of Association and examine the legality or otherwise of creating a secret reserve. He should see whether the intentions of directors are quite honest.
3. He should try to collect as much information as possible about the creation of a secret reserve. He should satisfy himself about the method and the procedure of creating such a reserve.

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4. Sometimes the managements create secret reserves by means of overvaluing liabilities or undervaluing assets. In such cases, the auditor should discuss the issue with the management and go deep into the policy and practices behind it.
5. Unless it is felt absolutely necessary to create a secret reserve, he should not accept the creation of a secret reserve as valid and if he feels so he should ask the management to prepare the revised annual accounts.

5. Reserve Fund

The word "**Fund**" in relation to any reserve can be used only where such a reserve is specifically represented by earmarked investments. In other words, the expression "**Reserve Fund**" is used only when there are earmarked investments for it; otherwise it is called only "**General Reserve**". Thus the expression reserve fund may be defined as "*A sum set aside out of divisible profits and retained in the business so as to provide for unexpected or unknown future contingencies or losses or to equalise dividends or to strengthen the financial position of a business concern*".

A reserve fund cannot exist, side by side, with the debit balance on Profit and Loss Account. Thus, if there is a debit balance in the Profit and Loss Account it must be shown as a deduction from the Reserve Fund or General Reserve under the heading Reserves and Surplus on the liabilities side of the Balance Sheet.

Under section 80 of the Companies Act, whenever a company redeems its preference shares without issuing fresh shares, it has to transfer from its profits, which are available for distribution, a sum equal to the nominal value of the preference shares so redeemed, to the capital redemption reserve. This reserve can be utilised by the company only for issuing fully paid-up bonus shares to its members.

In the absence of special Articles to the contrary, the directors of a company may transfer the whole or any portion of the Reserve Fund to the credit of Profit and Loss Appropriation Account for the purpose of increasing the amount of profit available for dividends.

Auditor's Duty

In case of reserve fund, the auditor should adopt the following procedure to verify it:

1. The auditor should see that a reserve fund is shown separately on the liability side of the Balance Sheet.
2. He should see that fund is created for meeting the earmarked purpose.
3. He should see that the amount of reserve fund is invested in easily realisable securities.
4. He should ascertain that the amount invested in outside securities is not less than the amount of reserve fund.

6. Sinking Fund

A sinking fund is a fund, which is created with a specific purpose such as-

1. To redeem or repay a long term liability such as debenture, long term loans, etc.
2. To replace a wasting asset, such as a mine.
3. To replace an asset of depreciable nature such as plant & machinery, land & buildings, etc.
4. To renew a lease.

In case of sinking fund, every year a fixed sum of money is set aside for a definite period, which is invested at compound interest, so that at the end of the period the annual amounts, with interest accumulation, will be sufficient to repay the outstanding loan. In such cases, the amount set aside should not be debited to Profit and Loss Account, but to Profit and Loss Appropriation

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Account because in case of repayment of liability, the sum set aside is in the nature of allocation of profits and not a charge against them.

Auditor's Duty

In case of sinking fund, the auditor should keep the following points in mind:

1. Auditor should see that a sinking fund is created as per the provisions of the Articles of Association as it was held in the case of **Davar & Sons Ltd. V. M.S. Krishna Swami.**
2. He should be familiar with the terms and conditions regarding the creation of a sinking fund and see that they have been duly complied with.
3. He should check the charge made to profit towards the sinking fund account.
4. He should ensure that the amount of sinking fund is properly invested in easily marketable securities.
5. He should see that the interest on investment is received and accounted in the books of accounts as per the investment deed.
6. He should verify that the investment against sinking fund is clearly shown separately in the Balance Sheet.
7. He should see whether the sinking fund investments are sold on the due date and also that the profit or loss made on realisation of investment is transferred to the Sinking Fund Accounts only and not to Profit and Loss Account.

II. PROVISION

If some loss is anticipated but its exact amount cannot be ascertained, a provision is made. Such provisions may be made either to provide for losses, which may arise on the realisation of certain assets, or on accruing liabilities. The exact amount cannot readily be made known for the present in cases such as provision for bad debts, provision for discount, provision for taxation, etc.

According to Part III of Schedule VI to the Companies Act, a provision means "*Any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy*".

CHARACTERISTICS OF PROVISION

The following are the important characteristics of provision:

1. It is an amount set aside out of profit.
2. Its object is to meet any known contingency.
3. The exact amount of loss cannot be ascertained.

PURPOSE OF CREATING PROVISION

Provisions may be created for the following purposes:

1. To meet outstanding liabilities for expenses such as outstanding salaries and wages, commission and income tax, provisions for bills likely to be dishonoured, etc.
2. To write off losses arising due to depreciation or diminution in assets such as depreciation, heavy repairs, etc.
3. To meet a specific contingency such as provision for bad and doubtful debts, discount on debentures, etc.

A provision is not a surplus and so it is not available for distribution among the shareholders.

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DIFFERENCE BETWEEN RESERVES AND PROVISION

The points of distinction between reserves and provision are given in Table 11.1.

S. No.	BASES	RESERVES	PROVISION
1.	Method of Creation	It is created by debiting Profit and Loss Appropriation Account.	It is made by debiting Profit and Loss Account.
2.	Necessity for Creation	It is a question of business policy of a concern and not compulsory.	The creation provisions is compulsory.
3.	Object	A reserve is a sum for an unknown liability.	A provision is a sum for a known liability.
4.	Feature	It strengthens the financial position of a business. It adds to the amount of working capital.	It meets out a specific loss on realisation of an asset or an accruing liability. It is for meeting out an anticipated loss or liability.
5.	Need	It depends upon financial policy of a concern.	It depends upon financial urgency to make a provision. It is a "*must*".
6.	Amount	The amount of a reserve depends upon the policy and discretion of the management.	The amount of a provision cannot be ascertained accurately at the date of the Balance Sheet, though the liability is known.
7.	Available for the Distribution of Dividends	It is available for distribution as dividend.	It is not so available.
8.	Nature	It is an appropriation of profits. If there are profits, reserve will be created, otherwise no reserve need to be created.	It is a charge against profits. It means that if there is a loss in a company, provision is a "*must*" and has to be made.
9.	Exhibited	Shown on the liability side of the Balance Sheet.	It is shown on both the sides of Balance Sheet.
10.	Utilisation	Amount can be utilised for any purpose because they represent undistributed profits.	Amount cannot be utilised for purposes other than that for which they are created

TABLE 11.1 DIFFERENCE BETWEEN RESERVES AND PROVISION

ITOR'S DUTY

The auditor's duties in connection with provision are as follows:

1. The auditor should thoroughly check the sums provided against a specific loss or liability.
2. He should go through all the relevant documents and ensure that all known losses, liabilities and contingencies have been duly provided for in the provisions.
3. He should satisfy that the provisions created are sufficient to meet the specified liability. If the provisions created are not adequate, auditor should mention the fact in his report.

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REVIEW QUESTIONS

Part - A

1. Define the term reserve.
2. What are the different types of reserves?
3. What is secret reserve?
4. What is reserve capital?
5. Define the term provision.
6. State any two object of creating specific reserve.

Part - B

1. What are the characteristics of reserves?
2. Distinguish between reserve and reserve fund?
3. What are the objects of creating general reserve? Discuss the duty of an auditor in regard to general reserve?
4. What is sinking fund? What is the duty of an auditor in regard to sinking fund?
5. How is secret reserve created? What are the objects of creating secret reserve?
6. What is capital reserve? What are its objects?
7. How is capital reserve utilised? What are the duties of an auditor in regard to capital reserve?
8. What is specific reserve? What are the duties of an auditor in regard to specific reserve?
9. What are the dangers involved in the creation of secret reserve?

Part - C

1. What is secret reserve? What are the objects of creating secret reserves? Discuss briefly the duties of an auditor in regard to secret reserve?
2. What do you understand by capital reserve? To what purposes may a capital reserve be applied?
3. Distinguish between a "Reserve" and a "Provision" and state your duty as an auditor in relation thereto.
4. What are secret reserves? How are they created? Give your views on the desirability of such reserves. What is the duty of an auditor when he discovers their existence?
5. What is a secret reserve? What is an auditor's duty in connection therewith?
6. What do you mean by sinking fund? What is the difference between a sinking fund to replace an asset and a sinking fund to repay a liability? What is the duty of an auditor in respect of sinking fund?
7. What are the objects of secret reserves? State how they are created and give a few reasons in support of and against them respectively. Explain the duty of an auditor regarding their verification and disclosure.
8. Mention the different kinds of reserves and explain the duties of an auditor in respect of such reserves.
9. What is secret reserve? What are the different ways of creating secret reserves? What is the position of secret reserves under the Companies Act, 1956?
10. What are the duties of an auditor regarding the maintenance of reserve?

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AUDITOR OF A COMPANY
APPOINTMENT, RIGHTS, AND DUTIES

12
CHAPTER

Need for Audit - Legal Provisions Regarding the Auditor - Other Kinds of Audit Under the Act.

NEED FOR AUDIT

In case of sole trading concerns and partnership firms, the ownership and control lies with the same person or persons. But in case of a joint stock company, the ownership lies with the shareholders and the control lies with the directors. The monetary stake of the directors is also very negligible when compared with the bulk of the share capital contributed by other shareholders. The money of the public should be kept safer and their interests to be protected. At the same time, the day-to-day administration of the company should not be hampered. Therefore, the Company Legislation has envisaged a compulsory audit for companies. The law further prescribes that only a qualified person can be appointed as the auditor of a company. Since the auditor undertakes this task on behalf of the shareholders, he is endowed with a number of powers, which the owners of all business undertakings shall generally have. His duties are also specified in the Act. His responsibilities are mentioned therein.

LEGAL PROVISIONS REGARDING THE AUDITOR

The sections 224 to 233 of the Companies Act contain elaborate provisions regarding the auditor of a company. The following are the provisions of law regarding qualification, disqualification, appointment, re-appointment, removal, rights, duties, and report of the auditor.

Qualifications of an Auditor

According to Sec. 226 of the Companies Act, only a qualified Chartered Accountant, within the meaning of the Chartered Accountants Act of 1949, should be appointed as an auditor of a company. If a partnership firm is appointed as the auditors, all the partners practising in India should be qualified Chartered Accountants. The object of this provision is to ensure that only a person with approved ability, experience and education is appointed as the auditor.

Besides, section 226(2) allows a holder of a certificate in an erstwhile Part B State, which entitled him to act as an auditor of companies in the jurisdiction of that State, to be appointed as an auditor of companies registered anywhere in India.

These provisions made eligible the persons who were authorised to do so, before the commencement of Part B State (laws) in 1951. These provisions are in reality not relevant today. Hence, it can be said that only practising Chartered Accountants can be appointed as auditors of a company.

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Disqualifications of an Auditor

Sec. 226(3) of the Act specifies that the following persons cannot be appointed as the auditor of a company:

1. Body corporate.
2. An officer or an employee of the company.
3. A person who is a partner or employee of an officer of the company.
4. A person who is indebted to the company for an amount exceeding Rs.1,000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees.
5. A person holding any security of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000.

Explanation: For the purposes of this section, "**Security**" means an instrument, which carries voting rights.

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

If an auditor becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) and (4), he shall be deemed to have vacated his office as such [Sec. 226(5)].

The object of this provision is to ensure independence of the auditor. A body corporate being an artificial person cannot attain professional qualifications. Hence, debarred from appointment. Others may be influenced by the management and shall not work independently. Therefore, they are also prohibited from appointment.

Appointment of an Auditor

Section 224 of the Act lays down the following provisions regarding the appointment of an auditor:

1) First Auditor of a Company [Sec. 224(5)]

The Board appoints the first auditor within one month from the date of registration of the company. He will hold the office till the end of the First Annual General Meeting. He should certify the Statutory Report. However, the company may, at a general meeting, remove any such auditor or all or any of such auditors and appoint in his or their places any other person or persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting.

If the Board fails to exercise its powers under this sub-section, the company in general meeting may appoint the first auditor or auditors.

2) Subsequent Auditors [Sec. 224]

Every company, at each Annual General Meeting, should appoint an auditor. The auditor will hold office from the conclusion of that meeting till the conclusion of the next Annual General Meeting. The following procedure is prescribed by the Act:

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1. The company should give an intimation regarding his appointment to the auditor within 7 days from the date of appointment.
2. The auditor within 30 days of receipt of such intimation should inform the Registrar, in writing, that he has accepted the appointment or refused it. The intimation should be in the prescribed form [Sec. 224(1)].

3) Appointment by the Central Government [Sec. 224(3)]

If the company fails to appoint or re-appoint an auditor in the Annual General Meeting, the management should notify the fact to the Central Government within 7 days of the date of the meeting. The Central Government, on receipt of such intimation may appoint the auditor to fill the vacancy. Any default to intimate the same, shall make the company and every officer liable with fine up to Rs.5,000.

4) Casual Vacancy [Sec. 224(6)]

The Board of directors can fill up the casual vacancy that arises in the office of the auditor except by his resignation. That is if a casual vacancy of the auditor arises due to death, insanity, insolvency or other disqualification the Board of Directors can fill the same under Sec. 224(6). In case of resignation, only the members in the General Meeting can fill up the vacancy. The auditor appointed for the casual vacancy shall hold office till the conclusion of the next Annual General Meeting.

5) Defective Appointment

Where the appointment of a person as an auditor is defective or invalid from the very beginning, the shareholders only can make the fresh appointment in the subsequent General Meeting of the company.

6) Auditor not to be Appointed except with the Approval of the Company by Special Resolution in Certain Cases [Sec. 224A]

In the case of a company in which not less than twenty-five per cent of the subscribed share capital is held, whether singly or in any combination, by any of the following institutions the appointment or re-appointment at each Annual General Meeting of an auditor or auditors shall be made by a special resolution:

(a) a public financial institution or a Government company or Central Government or any State Government holds not less than fifty-one per cent of the subscribed share capital, or
(b) any financial or other institution established by any Provincial or State Act in which a State Government holds not less than fifty-one per cent of the subscribed share capital, or
(c) a nationalised bank or an insurance company carrying on general insurance business [Sec. 224A(1)].

If any company referred to in sub-section (1) omits or fails to pass at its Annual General Meeting any special resolution appointing an auditor or auditors, it shall be deemed that no auditor or auditors had been appointed by the company at its Annual General Meeting, and thereupon the provisions of sub-section (3) of section 224 shall become applicable in relation to such company [Sec. 224A(2)].

7) Compulsory Reappointment of the Retiring Auditor [Sec. 224(7)]

The Act envisages the compulsory reappointment of the retiring auditor. The company should appoint only the retiring auditor unless:

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a) he is not qualified for reappointment.
b) he has given the company a notice, in writing, stating his unwillingness to be reappointed.
c) a resolution has been passed at the meeting appointing some other person as the auditor.
d) a resolution providing expressly that he shall not be re-appointed is passed.
e) where a notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor but due to the person's death, incapacity or disqualification, the resolution cannot be proceeded with and so must be dropped.

It is quite possible that a qualified auditor becomes disqualified. For instance, his name can be removed from the list of Members of the Institute of Chartered Accountants for misconduct. If so, he shall become disqualified. The retiring auditor should be reappointed irrespective of the fact whether the Board or Government or members appoint him.

Reappointment of the retiring auditor shall also not be made, if he is already holding auditorship in the specified number of companies.

8) Appointment of Auditors of Government or Certain other Companies [Sec. 619]

The auditor of a Government company shall be appointed or re-appointed by the Comptroller and Auditor-General of India. However, the limits specified in sub-sections (1B) and (1C) of section 224 shall apply in relation to the appointment or re-appointment of an auditor under this sub-section [Sec. 619(2)].

The Comptroller and Auditor-General of India shall have power-

(a) to direct the manner in which the company's accounts shall be audited by the auditor appointed in pursuance of sub-section (2) and to give such auditor instructions in regard to any matter relating to the performance of his functions as such;
(b) to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorise in this behalf; and for the purposes of such audit, to require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General may, by general or special order, direct [Sec. 619(3)].

The auditor aforesaid shall submit a copy of his audit report to the Comptroller and Auditor-General of India who shall have the right to comment upon, or supplement, the audit report in such manner as he may think fit [Sec. 619(4)].

Any such comments upon, or supplement, to the audit report shall be placed before the annual general meeting of the company at the same time and in the same manner as the audit report [Sec. 619(5)].

Annual Reports on Government Companies [Sec. 619A]

Where the Central Government is a member of a Government company, the Central Government shall cause an annual report on the working and affairs of that company to be-

(a) prepared within three months of its annual general meeting before which the audit report is placed under sub-section (5) of section 619; and
(b) as soon as may be after such preparation, laid before both Houses of Parliament together with a copy of the audit report and any comments upon, or supplement to, the audit report, made by the Comptroller and Auditor-General of India [Sec. 619A(1)].

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Where in addition to the Central Government, any State Government is also a member of a Government Company, that State Government shall cause a copy of the annual report prepared under sub-section (1) to be laid before the House or both Houses of the State Legislature together with a copy of the audit report and the comments or supplement referred to in sub-section (1) [Sec. 619A(2)].

Where the Central Government is not a member of a Government company, every State Government which is a member of that company, or where only one State Government is a member of the company, that State Government shall cause an annual report on the working and affairs of the company to be-

(a) prepared within the time specified in sub-section (1); and
(b) as soon as may be after such preparation laid before the House or both Houses of the State Legislature with a copy of the audit report and comments or supplement referred to in sub-section (1) [Sec. 619A(3)].

The provisions of this section shall, so far as may be, apply to a Government Company in liquidation as they apply to any other Government company [Sec. 619A(4)].

Provisions of Section 619 to Apply to Certain Companies [Sec. 619(B)]

The provisions of section 619 shall apply to a company in which one or more of the following or any combination thereof holds not less than fifty-one per cent of the paid-up share capital, as if it were a Government company, namely:

(a) the Central Government and one or more Government companies.
(b) any State Government or Governments and one or more Government companies.
(c) the Central Government, one or more State Governments and one or more Government companies.
(d) the Central Government and one or more corporations owned or controlled by the Central Government.
(e) the Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government.
(f) one or more corporations owned or controlled by the Central Government or the State Government.
(g) more than one Government company.

Removal of an Auditor

The Companies Act makes special and detailed provisions regarding the removal of an auditor. The object of these provisions is to ensure justice and fair play, to avoid the unjustifiable removal of honest auditors who refuses to dance according to the tune of the directors and to maintain the esteem of this profession. As a rule only the members of the company in a General Meeting can remove the auditor. He can be removed either at the expiry of the term of office or even before the expiry of his term.

(I) Removal at the Expiry of the Term or Provisions as to Resolutions for Appointing or Removing Auditors [Sec. 225]

The following procedure is laid down to remove the auditor at the expiry of the term:

1. A special notice mentioning the desire to appoint some other person in the place of the retiring auditor should be sent to the company by the shareholders at least 14 days before the date of the Annual General Meeting. The name of the auditor proposed for appointment must be mentioned in the notice.
2. On receipt of such notice the company must forthwith send a copy thereto to the retiring auditor.

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3. The special notice may also be in the form that the retiring auditor should not be reappointed. In such a case the person who sends the notice need not mention the name of the auditor to be appointed. He may leave it to the desire of the members.
4. The retiring auditor has a right to send his representations in writing to the company. On receipt of such representation the company should send a copy of it to each member.
5. If the representation is not circulated amongst the members due to practical difficulties, the auditor can ask the company to read out his representation in the meeting.
6. The auditor is also having a right to attend the general meeting where his removal shall be discussed. He is also entitled to speak at the meeting.
7. However the copies of the representations need not be sent out and the representations need not be read out at the meeting if, on the application either of the company or of any other person who claims to be aggrieved, the Central Government is satisfied that the rights conferred by this sub-section are being abused to secure needless publicity for defamatory matter; and Central Government may order the company's costs on such an application to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application.

The above said provisions shall apply to a resolution to remove the first auditors or any of them under sub-section (5) of section 224 or to the removal of any auditor or auditors under sub-section (7) of that section, as they apply in relation to a resolution that a retiring auditor shall not be re-appointed [Sec. 225(4)].

2) Removal Before the Expiry of the Term

The following procedure should be followed in addition to the usual procedure laid above:

1. If auditor is to be removed even before the expiry of the term, a special notice intimating the desire should be sent at least 14 days before the General Meeting.
2. The prior sanction of the Central Government is necessary for the removal. However, it is not necessary in the case of the first auditor.
3. The other provisions applicable to the removal of the auditor after the expiry of term shall apply here also.

Term of the Auditor

What is the term of the appointment of an auditor? Is it one year or an accounting year? The answer to the question is "**No**". Section 224(1) provides that an auditor is appointed from the conclusion of one annual general meeting until the conclusion of next annual general meeting. If the annual general meeting is delayed or adjourned the tenure of the auditor will also get extended. It seems that the duty of an auditor cannot be regarded as one restricted to auditing the accounts of a particular year as section 227(2) requires an auditor to report on every Balance Sheet and the Profit and Loss Account which are laid before the company in general meeting during the tenure of his office.

Restriction on Number of Auditorships [Sec. 224(1B) & (1C)]

Sec. 224(1B) states that on and from the financial year next following the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), no company or its Board of directors shall appoint or re-appoint any person (who is in full-time employment elsewhere) or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies. Now it is specified as 20 companies.

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However, in case of a firm of auditors, "**Specified Number of Companies**" shall be construed as the number of companies specified for every partner of the firm who is not in full-time employment elsewhere.

Further, where any partner of the firm is also a partner of any other firm or firms of auditors, the number of companies, which may be taken into account, by all the firms together, in relation to such partner shall not exceed the specified number, in the aggregate.

Further more, where any partner of a firm of auditors is also holding office, in his individual capacity, as the auditor of one or more companies, the number of companies which may be taken into account in his case shall not exceed the specified number, in the aggregate-

It is provided further that the provisions of this sub-section shall not apply, on and after the commencement of the Companies (Amendment) Act, 2000, to a private company.

For the purpose of enabling a company to comply with the above said provisions, a person or firm holding, immediately before the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), appointment as the auditor of a number of companies exceeding the specified number, shall, within sixty days from such commencement, intimate his or its unwillingness to be re-appointed as the auditor; and shall simultaneously intimate to the Registrar the names of the companies of which he or it is willing to be re-appointed as the auditor and forward a copy of the intimation to each of the companies referred to therein [Sec. 224(1C)].

In counting the number of assignments the audit of head office and branch or branches shall be counted as one. The number of assignments he or any partner of his firm has singly or in combination with any other Chartered Accountant or Firm of Chartered Accountants shall be counted.

On 19th May 2001 the Institute of Chartered Accountants of India prescribed that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the specified number of audit assignments of the companies under section 224 and or section 228 of the Companies Act, 1956.

For the purposes of sub-sections (1B) & (1C) of Sec. 224, the specified number of audit assignment means:

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

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

In computing the specified number, the number of companies in respect of which or any part of which any person or firm has been appointed as an auditor, whether singly or in combination with any other person or firm, shall be taken into account.

The collective reading of the provisions means an auditor under section 224(1B) of the Companies Act 1956, can accept 20 assignments of audit of public companies out of which not more than 10 shall have paid up capital of Rs.25 lakh or more.

Legal Status of the Auditor

The exact legal status of an auditor is the agent of the shareholders. However, he is also considered as an officer of the company under certain circumstances. Hence, we shall discuss his status under two heads as follows:

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1) As an Agent of the Shareholders

The auditor, as a rule is considered as the agent of the shareholders because they appoint him. Even though the Government or the directors appoint him he is the agent of the shareholders only.

The reason is obvious. As an agent, he has to safeguard the interests of the shareholders. Highlighting the exact status of the auditor, **Justice Chakravarthi** observed as follows-

"A joint stock company carries on business with capital furnished by persons who buy its shares. The owners of the capital are, however, not in direct control of its application... The Act therefore, provides for the employment of an auditor who is the servant of the shareholders and whose duty is to examine the affairs of the company on their behalf...The examination by independent agency such as the auditor is practically the only safeguard which the shareholders have" **(Deputy Secretary to the Government of India *V.* S.N. Das Gupta).**

In the course of the judgement delivered by **Lord Cranworth** in **Spackmen *V.* Evans,** it was said as follows:

"The auditor may be the agent of the shareholders so far as related to the audit of the accounts".

Thus, it appears that the auditor is the agent of the shareholders so far as the audit of accounts is concerned.

2) As an Officer of the Company

Under certain specified circumstances, the auditor is deemed to be an officer of the company. In other words, he is not an officer actually, but the Act considers the auditor as an officer in eight specified instances.

Is an Auditor a Servant?

Now the crucial question is whether the auditor is a servant or not? Divergent views were expressed on this point. One view is as follows. He is paid by the company and appointed by the real owners of the company. Hence he is the servant of the company. The contrary view is that the company like any other employee does not appoint him. He does not work only for one company. He can take up the audit work of more than one company simultaneously. This is not possible in case of other employees. Moreover, an employee cannot assign the job entrusted by the company to some other person whereas the auditor can assign his work to his juniors.

From the foregoing discussion we cannot conclude whether the auditor is an employee or not. It is still a question of much dispute and interpretation.

Remuneration to the Auditor [Sec. 224(8)]

The remuneration of the auditors of a company-

1. in the case of an auditor appointed by the Board or the Central Government, may be fixed by the Board or the Central Government, as the case may be.
2. in the case of an auditor appointed under section 619 by the Comptroller and Auditor General of India, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.
3. subject to the provisions of point 1. above, it shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

For the purposes of this sub-section, any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression **"Remuneration".**

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Powers of an Auditor

The Companies Act confers extensive powers on the auditor. Since, he is the agent of the shareholders, he is having all the powers, which other business owners shall generally have. Specific provisions are made in the Act and so the auditor cannot be prevented by anybody in the universe from the enjoyment of these rights. The following are the statutory rights of an auditor:

1) **Right to Access to Books of Accounts:** The auditor has a right of access to books of account, vouchers, and relevant documents of the company at all times during his term of office. Therefore, the auditor can even pay a surprise visit and check the entries in the books of accounts. But usually the auditor does not make such visits [Sec. 227(1)].

2) **Right to Obtain Information and Explanations:** The auditor has a right to obtain whatever information or explanation he requires in performing his duty. The person from whom the auditor requires such explanation must provide the same. The person may be the Managing Director, Director, Manager or any other officer or employee. If any information sought by the auditor is refused, he should report the matter to the members [Sec. 227(1)].

3) **Right to make Suggestions to the Board:** The auditor is also having a right to suggest suitable modifications in the method of accounting followed by the management. The directors if a suggestion is made, should comply with it. If not, the auditor should report the same to the members. But he has no right to make any alteration in the accounts of the company on his own accord.

4) **Right to Visit Branches [Sec. 228(2)]:** The auditor is also entitled to visit the branches of the company. However, if a qualified auditor audits the accounts of the branch, he can get copies of the accounts certified by the branch auditor, and always has access over such documents. The auditor has no statutory right to visit foreign branches.

5) **Right to Receive Notice and Attend Meetings [Sec. 231]:** The auditor has a right to receive all notices and communications relating to all general meetings during his term. Even if the accounts audited by him are not discussed, the company should send a notice to the auditor. The auditor is also entitled to attend the meetings. He can also speak at the meeting if any clarification is needed from him.

6) **Right to Sign the Audit Report [Sec. 229]:** Only the auditor can sign the Auditor's Report. If a firm is appointed, any partner practising in India can sign. The first auditor should sign and authenticate a particular part of the Statutory Report. Besides he has a right to sign and authenticate any other document, which the Act requires to furnish.

7) **Right to Remuneration:** He has a right to receive the remuneration fixed by the appointing authority. In the event of winding up, he can also rank as a creditor for the amount due. However, he can claim the amount only after completing the work fully and entirely.

8) **Right to be Indemnified:** The company under certain circumstances can take both civil and criminal proceedings against the auditor. If legal action is taken against him, he will generally defend himself against the proceedings. If the judgement goes to his favour or he is acquitted, the company should compensate the loss incurred by him in defending the suit.

9) **Right to take Legal and Technical Advice:** The auditor has a right to take advice or opinion of legal and technical experts if there is a need for it.

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Duties of the Auditor

The duties of an auditor are many and varied. The Companies Act lays down specific duties with a view to preserve the interests of the shareholders. These duties are statutory duties and the auditor cannot avoid any of them. Besides, various judicial decisions have also imposed certain duties, which can be discussed under three heads viz.:

1. Statutory Duties.
2. Duties Imposed by the Court of Law.
3. Other Duties.

1) Statutory Duties of the Auditor

The following are the statutory duties specified by the Companies Act.

(1) Duty to Enquire [Sec. 227(1A)]

The auditor can enquire into any matter connected with the entries in the books of account. He can call for any information or explanation. He can also examine the relevant documents. In particular, the auditor should enquire certain specific matters under Sec. 227(1A) of the Act. They are as follows:

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

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

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

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

(e) whether personal expenses have been charged to revenue account;

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

(2) Duty to Report [Sec. 227(2) & (3)]

The auditor shall make a report to the members of the company on the accounts examined by him, and on every Balance Sheet and Profit and Loss Account and on every other document declared by this Act to be part of or annexed to the Balance Sheet or Profit and Loss Account, which are laid before the company in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in the manner so required and give a true and fair view:

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

(ii) in the case of the Profit and Loss Account, of the profit or loss for its financial year [Sec. 227(2)].

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The auditor's report shall also state-

(a) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

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

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

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

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

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

(g) whether the cess payable under section 441A has been paid and if not, the details of amount of cess not so paid [Sec. 227(3)].

(3) Duties under Section 227(4A) of the Companies Act

Section 227(4A) empowers the central Government to direct by a general or specific order that in the case of specific companies, the auditor's report shall include a statement on such matters as may be specified into its orders. As such it is the duty of the auditor to include it in the audit report of such companies a statement on all such matters as may be specified in the Government orders. In exercise of the power conferred by section 227(4) of the Act, the Central Government in consultation with the Institute of Chartered Accountants of India has issued the Companies (Auditor's Report) Order, 2003 i.e., CARO, 2003. The CARO, 2003 shall apply to every company including a foreign company as defined in section 591 of the Act, except the following:

(i) a Banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);

(ii) an insurance company as defined in clause (21) of section 2 of the Act;

(iii) a company licensed to operate under section 25 of the Act; and

(iv) a private limited company with a paid up capital and reserves not more than rupees fifty lakh and which does not have loan outstanding exceeding rupees twenty-five lakh from any bank or financial institution and does not have a turnover exceeding rupees five crore at any point of time during the financial year.

Consequently, it has become the duty of an auditor to give detailed comment on the matters mentioned in the order in respect of the companies to which the order is applicable.

(4) Other Duties under Company Law

Besides these three principal duties, Law also casts a number of duties upon the auditor. They are given briefly as below:

1. To certify a statement of the Profit or Losses, Assets and Liabilities, Rates of dividend, etc. for the previous years for the purpose of issuing a prospectus.
2. To certify the Statutory Report (in case of first auditor).

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3. To make a report about its solvency when the company goes into voluntary winding up.
4. To assist the inspectors appointed by the Government for investigation.
5. To assist the Central Government if any prosecution proceedings are taken by it against the management.

2) Duties Imposed by the Court of Law

Besides the duties referred above, the Judicature has also imposed a number of duties upon the auditor. These duties are-

1. The auditor should have a complete knowledge of all the documents of the company.
2. He should not be negligent in performing his duties. He should be careful and cautious.
3. He should be honest in performing his duties. He should not certify a statement, which is untrue.
4. He should not confine himself with the arithmetical accuracy of the books. But he should see that the transactions are fact and genuine.
5. He should physically verify the assets of the company wherever possible. In other cases, however, he can rely on the valuations made by the trusted servants of the company.
6. The report should be clear and not misleading.

3) Other Duties

(1) Contractual Duties

A company for purposes other than the statutory audit may hire a Professional Accountant. In all such cases the duty of the auditor will depend upon the terms and condition of his appointment.

(2) Duties of Auditor in relation to Mandatory Accounting Standards

According to the decision of the Council of the Institute of Chartered Accountants of India, it has been resolved that while discharging their attest functions, it will be the duty of the members of the institute, to ensure that the Auditing and Assurance Standards (AASs) and Accounting Standards (ASs) are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the standards, it will also be their duty to make adequate disclosures in their reports so that the users of such statements may be aware of such deviations.

(3) Professional Duties

Every profession governs itself through code of conduct or ethics. The members of the profession of accounting are also expected to observe ethics given to them by the Institute of Chartered Accountants of India. For example when a person is appointed as auditor of a company, he should correspond with the previous auditor before accepting the assignment.

OTHER KINDS OF AUDIT UNDER THE ACT

The audit of a company is generally done once in a year. Hence, known as Annual Audit. In addition to this, there are four kinds of audit envisaged by the Companies Act. They are the following:

1. Branch Audit.
2. Social Audit.
3. Special Audit.
4. Cost Audit.

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1. Branch Audit

Branch audit is not a separate kind of audit. It is only a part of the annual audit. If a company has a branch, the auditor of the company should also audit the accounts of the branch office. The trading results of the branch office should be incorporated in the Annual Accounts of the Head Office and a consolidated Profit and Loss Account and Balance Sheet are to be laid before the Annual General Meeting. But the time has now changed. Companies, with sound financial standing open branches throughout the country and even abroad. Each branch is doing business equally with the Head Office. Therefore, it is practically impossible for the auditor to audit the branch accounts within a shorter period of time. Besides, the company has to bear all his expenses there. Moreover, young Chartered Accountants should be given encouragement to set up independent practice. For this new opportunities should be created and new avenues are to be opened. Bearing all these points in mind, the Parliament has suitably amended the Companies Act, whereby companies are now allowed to appoint separate auditors for their branches in addition to the company auditor. The auditor so appointed to audit the branch office is known as the Branch Auditor. Sec. 228 of the Act deals with the accounts of branch office of company. It states that where a company has a branch office, the accounts of that office shall be audited by the company's auditor appointed under section 224 or by a person qualified for appointment as auditor of the company under section 226, or where the branch office is situate in a country outside India, either by the company's auditor or a person qualified as aforesaid or by an accountant duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country [Sec. 228(1)].

Whether the accounts of any branch office are audited by a person other than the company's auditor the company's auditor-

(a) shall be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor, and

(b) shall have a right of access at all times to the books and accounts and vouchers of the company maintained at the branch office.

However, that in the case of a banking company having a branch office outside India, it shall be sufficient if the auditor is allowed access to such copies of, and extracts from, the books and accounts of the branch as have been transmitted to the principal office of the company in India [Sec. 228(2)].

Where a company in general meeting decides to have the accounts of a branch office audited otherwise than by the company's auditor, the company in that meeting shall for the audit of those accounts appoint a person qualified for appointment as auditor of the company under section 226, or where the branch office is situate in a country outside India, a person who is either qualified as aforesaid or an accountant duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country, or authorise the Board of directors to appoint such a person in consultation with the company's auditor [Sec. 228(3)(a)].

The person so appointed (hereafter in this section referred to as the branch auditor) shall have the same powers and duties in respect of audit of the accounts of the branch office as the company's auditor has in respect of the same [Sec. 228(3)(b)].

The branch auditor shall prepare a report on the accounts of the branch office examined by him and forward the same to the company's auditor, who shall in preparing the auditor's report, deal with the same in such manner, as he considers necessary [Sec. 228(3)(c)].

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The branch auditor shall receive such remuneration and shall hold his appointment subject to such terms and conditions as may be fixed either by the company in general meeting or by the Board of directors if so authorised by the company in general meeting [Sec. 228(3)(d)].

However, the Central Government may make rules providing for the exemption of any branch office from the provisions of this section to the extent specified in the rules and in making such rules the Central Government shall have regard to all or any of the following matters, namely:

(a) the arrangement made by the company for the audit of accounts of the branch office by a person otherwise qualified for appointment as branch auditor even though such person may be an officer or employee of the company;

(b) the nature and quantum of activity carried on at the branch office during a period of three years immediately preceding the date on which the branch office is exempted from the provisions of this section;

(c) the availability at a reasonable cost of a branch auditor for the audit of accounts of the branch office;

(d) any other matter, which in the opinion of the Central Government justifies the grant of exemption to the branch office from the provisions of this section [Sec. 228(4)].

To sum up-

i) The branch auditor should also be appointed in the General Meeting. However, the members may, by a resolution authorise the Board to appoint a branch auditor. If so authorised, the Board can appoint the branch auditor in consultation with the company's auditor.

ii) The appointing authority shall fix his remuneration i.e., the Board or the members as the case may be.

iii) The branch auditor has similar powers and duties as that of the company's auditor in respect of that branch only.

iv) The branch auditor should also have prescribed qualifications. If it is a foreign branch, the branch auditor should have the qualifications prescribed by that country for an auditor of a company there.

v) The branch auditor should submit his report to the company's auditor.

vi) The company's auditor has a right to visit the branch even if there is a branch auditor. If the branch is outside India, the company's auditor, however, has no such right.

2. Social Audit

Social audit also is not a separate category of audit. Under social audit the auditor of a company is required to include a statement on certain matters in his report. In a socialistic society, public participation in decision-making process is emphasised at least in theory. To achieve this end the Company Law is also suitably amended because Joint Stock Company is an institution, which utilises the public funds. Giant corporations, now-a-days, mobilise the resources of the country in a better way than the Government and other financial institutions. These resources should be effectively employed; put to productive uses and so it shall be helpful to the whole society. For this purpose, the Government may require the auditors of certain specified categories of companies to make a statement on certain specified matters and to include the statement in his report. The following points should be noted in this context.

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1. The government shall specify the class of categories of companies. The Government has announced the following classes of companies for this purpose.
   i) Manufacturing, Mining, Processing.
   ii) Supplying and Rendering Services.
   iii) Trading.
   iv) Financing, Investment, Chit fund, Nidhi, Mutual Benefit Funds.
2. The social audit is more concerned with the expenditure side. The statement to be made in the report should touch various matters of public concern. From the statement both the shareholders and the public can understand whether each and every expenditure has derived some benefit to the society or not.
3. This is only a kind of moral check because any negative statement shall make the management unpopular and so the people in the helm of affairs will take corrective action. Reputed managements, to maintain their reputation, will always see that no adverse remarks find a place in the auditor's report.

3. Special Audit

The Central Government is empowered under Section 233A of the Act to order for a special audit in the following circumstances:

1. If the affairs of the company are not managed in accordance with sound business principles and prudent commercial practices.
2. If the company is managed in a manner likely to cause serious injury or damage to the interests of the trade, business or industry concerned.
3. If the financial position is such as to endanger its solvency.

The Government can appoint any qualified Chartered Accountant specifically for this purpose. Even the company's own auditor may be appointed. The special auditor has similar powers to that of the company's auditor. The special auditor should make the report to the Government.

The report should contain his findings on all the matters referred to him for the purpose of the audit by the Government. On receipt of the report, the Government should take necessary action within four months. If not, a copy of the report should be sent to the company along with its comments. The company in turn should send a copy of the report along with the comments, to each member of the company. The company should meet the expenses of the special audit.

4. Cost Audit

Cost audit applies only to a few categories of companies engaged in manufacturing, mining etc. It is conducted in addition to the regular financial audit. Sec. 233B of the Companies Act deals with the cost audit the provisions of which are summarised below:

1. The cost auditor should be a qualified Cost Accountant. However, Chartered Accountants are also now allowed to act as cost auditors because of the non-availability of sufficient cost accountants.
2. The Board appoints the cost auditor with the previous approval of the Central Government. The sanction of the General Meeting is not necessary.
3. An auditor of a company cannot be appointed as its cost auditor.
4. The cost auditor shall have the same powers as that of the company's auditor.
5. He has to make the report direct to the Government. A copy of the report should be forwarded to the company.

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6. The company, within 30 days from the date of receipt of the copy of the report, should send its explanations or comments on the reservations or qualifications contained in the report.
7. On receipt of the report referred and the information and explanations furnished by the company the Central Government may take such action on the report, in accordance with the provisions of this Act or any other law for the time being in force, as it may consider necessary.
8. The Central Government may direct the company whose cost accounts have been audited under this section to circulate to its members, along with the notice of the annual general meeting to be held for the first time after the submission of such report, the whole or such portion of the said report as it may specify in this behalf.
9. If default is made in complying with the provisions of this section, the company shall be liable to the punished with fine which may extend to fifty thousand rupees and every officer of the company who is in default shall be liable to be punished with imprisonment for a term which may extend to three years, or with fine which may extend to fifty thousand rupees, or with both.

REVIEW QUESTIONS

Part - A

1. Who can be appointed as a company auditor?
2. Who are first auditors?
3. Who appoints the subsequent auditors?
4. What is casual vacancy?
5. Who can remove the auditor?
6. What is the term of the company's auditor?
7. What is social audit?
8. What is cost audit?

Part - B

1. What are the qualification and disqualifications of a company auditor?
2. Briefly enumerate the provisions of the Companies Act regarding the appointment of company auditors.
3. Discuss briefly the removal of company auditors.
4. Write about the restrictions on number of directorship.
5. Discuss the legal status of the company auditor.
6. Who fixes the remuneration of company auditor?

Part - C

1. Who are company auditors? Who appoints them? Write about the removal of company auditors.
2. Enumerate the powers and duties of company auditors.
3. Write a note on the following:
   1) Term of company auditors.
   2) Legal Status of company auditors.
   3) Special Audit.
   4) Branch Audit.
4. Summarise briefly the provisions of Companies Act regarding the appointment of auditors.

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LIABILITIES OF AN AUDITOR

13 CHAPTER

Introduction - Liabilities of a Company Auditor - Reliefs and Remedies to the Company Auditor.

INTRODUCTION

The liabilities of an auditor will depend upon, whether he carried out his work with care, skill, and diligence or not? If he performs his duty exercising his professional skills with care, and diligence, he will escape from the liability for non-detection of any fraud. However, if he is found to be negligent in the performance of his duties he cannot escape from the liabilities, and his liabilities will follow.

The auditor should be constantly aware of his possible legal obligation to his clients as well as third parties. In any society direct relationship exists between the responsibilities assigned to a profession and its social status. A profession acquires recognition only when it is prepared to discharge its responsibilities and to face consequences in case of failure to fulfil the requisite standards of performance. Therefore, an auditor should be ready to subject himself accountable for the quality of work performed by him. If he is not prepared to accept liabilities for his actions, the authentication of a statement by him will not have any meaning.

LIABILITIES OF A COMPANY AUDITOR

The liabilities of a company auditor who does not discharge their responsibilities properly can be broadly classified into four categories as shown in Fig. 13.1.

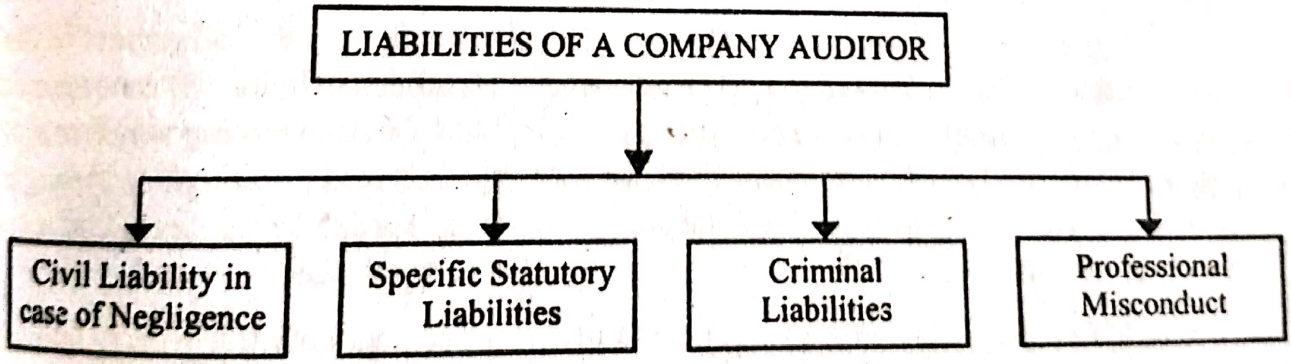


FIG. 13.1 LIABILITIES OF A COMPANY AUDITOR

1. Civil Liabilities in case of Negligence

Civil liabilities for negligence refer to a liability to pay compensatory damages to certain parties where an auditor in discharge of his duties does not exercise a reasonable degree of skill and care. As a Chartered Accountant is an expert qualified to perform a variety of professional services to the society at large, he is expected to discharge these services with due care and diligence and as per

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the generally accepted standards of performance. The absence of the requisite professional skill or the failure to exercise those skills can give rise to an action of damages for negligence against him.

The Parties to whom an Auditor is Liable

A chartered accountant clearly owes a duty to the person who appoints him because he has a direct contractual relationship with him. Thus, a statutory auditor is liable to the body of shareholders in the case of a company. He has a privity of contract with them.

It is a controversial legal question whether an auditor owes a duty of care to third parties like bankers, tax authorities and others with whom he has no privity of contract but who usually rely on statements reported upon by him. In the past, it was held that the auditor had no responsibility towards persons with whom he had no privity of contract.

In **Commissioner of Income Tax *V.* G.M. Dandekar,** it was held that "*since the income tax department did not employ the defending accountant, he owed no responsibility or duty to it and there was no negligence involved*".

Recently, however, Courts in the UK and the USA have not been accepting the legal principles enunciated above. Many recent judgements show that the Courts are taking a broader view of an auditor's liability. The legal position now seems to be that the auditor cannot escape liability to third parties in all circumstances.

Lord Denning, who dissented from the majority judgement in **Candler *V.* Crane Christmas and Co.**, argued that "*an auditor had social responsibilities and that the interpretation of law should not be so narrow and ridden with legal clichés as to deny social justice or equity*".

Lord Denning's viewpoint was upheld, thirteen years later, in ***Hedley Byrne Co. Ltd. V. Heller and Partners***. Thus, a professional accountant may be liable to third parties in certain circumstances.

The change in the legal view of professional accountants' liability is based upon two principles of law such as the doctrine of holding out, and the notion of proximity.

Lord Atkin further amplifies the doctrine of proximity- "*You must take reasonable care and skill to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbours-persons who are closely and directly affected by the act*".

In the UK, the auditor's liability to third parties has been limited by the judgement in the case of **Caparo Industries Plc *V.* Dickman and Other**, where it has been held that "*it is not possible to lay down through any single general principle, a practical test for determining whether a duty of care is owed by the maker of a statement to those who may suffer economic loss through their reliance on it*". The judgement also rejects the premise that if a loss can be foreseen, that is enough to create the proximity necessary to the existence of such a duty of care.

From the above discussion, it is evident that a professional accountant is clearly liable to the following parties:

1. In all cases, to his clients with whom he is in a contractual relationship.
2. To any person if his report is fraudulent.

Meaning of Negligence

Negligence means acting carelessly or failing to perform a duty enjoined upon a person. It is an act of commission or omission, which occurs because the person concerned has failed to exercise the degree of professional care and skill, which is expected of him under the circumstances of the case.

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An auditor should conduct audit with reasonable care and skill according to generally accepted auditing standards. This does not mean that he is required to undertake detailed investigations. He is, as has been said, "**A Watchdog but Not a Bloodhound**". However, if he fails to exercise reasonable care and skill according to generally accepted auditing standards, he would be liable for negligence.

Damages Arising out of Negligence

The damages that arise out of negligence are of two types as detailed below:

1. **Compensatory Damage:** Chartered accountants can be called upon to pay compensation to their clients or third parties only if the latter have suffered loss because of negligence on the part of them. Damages on account of negligence under a contract or under tort are compensatory is not given for any remote or indirect loss sustained by the client.

2. **Special Damage:** Special damage can be claimed only if the party alleged to be in default had knowledge of the circumstances and had accepted liability at the time of the making of the contract.

Important Legal Cases regarding Negligence on the Part of Auditors

The following cases are worth mentioning here:

Re Kingston Cotton Mills Co. Ltd

In Kingston Cotton Mills Co. Ltd case, it was held that an auditor could rely upon the statements of trusted officials of the company if there are no suspicious circumstances..... It is not also the duty of the auditor to undertake physical verification of stocks.

The Irish Woollen Co. Ltd. *V.* Tyson and Others

In the Irish Woollen Co. Ltd. V. Tyson and Others, it was held that an auditor is liable if dividends have been improperly paid out of capital due to such understatement of the liabilities of the company as could have been discovered by the exercise of reasonable skill and care.

The Leeds Estate Building and Investment Society Ltd. *V.* Shepherd

In the Leeds Estate Building and Investment Society Ltd. *V.* Shepherd, it was held that the auditor must see that the balance sheet is a true and an accurate representation of the company's affairs.

London Oil Storage Co. Ltd *V.* Sears, Hasluck & Co.

In London Oil Storage Co. Ltd *V.* Sears, Hasluck & Co., it was held that verification of the existence of assets stated in the balance sheet is an important duty of the auditor.

2. Specific Statutory Liability

1) Liabilities Under the Companies Act

Under the Companies Act, an auditor attracts both civil and criminal liabilities. However, under this head only civil liabilities are discussed and criminal liabilities are detailed under the subsequent heading.

1. **Liability for Misstatement in Prospectus:** The auditor is required to make certain reports in the prospectus of a company under the Companies Act as an expert. Section 62 of the Act lays down the civil liability for misstatement in a prospectus issued to invite persons to subscribe for shares in or debentures of a company. The auditor will in such a case be liable to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus for any

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loss or damage sustained because of an untrue statement made by him as an expert. The measure of damages under this section is the loss suffered by reason of the untrue statement.

However, an auditor will not be so liable if he can prove that:

1. the prospectus was issued without his knowledge or consent and that on becoming aware of its issue, he forthwith gave reasonable public notice that it was issued without his knowledge or consent; or
2. he withdrew his consent in writing before delivery of the prospectus for registration; or
3. after the delivery of the prospectus for registration but before allotment of shares, on becoming aware of the untrue statement, he withdrew his consent in writing and gave reasonable public notice of the withdrawal, and of the reasons therefor; or
4. he was competent to make the statement and that he had reasonable grounds to believe and did up to the time of allotment of the shares or debentures believe that the statement was true.

The civil liability under this section is in addition to the liability under the general law enforceable by suit for recovery of damages on the ground of fraud, etc.

2. **During Winding Up Proceedings:** Under section 477, The National Company Law Tribunal has powers to summon and examine any officer of the company or person including an auditor who is- (i) known or suspected to have in his possession any property, books or papers of the company or (ii) known or suspected to be indebted to the company or is deemed to be capable of giving information concerning the promotion, formation, trade, dealings, property, books, papers or affairs of the company.

The Tribunal may also require such a person to produce any books or papers of the company, which are in his custody. This power can be exercisable only after the appointment of a provisional liquidator or the making of a winding up order.

2. Liability under Consumer Protection Act, 1986

The Consumer Protection Act, 1986 provides for the better protection of interests of consumers. Sec. 2(d) of the Consumer Protection Act, 1986, which defines the term consumer, includes not only the persons who buy any goods but also the persons who hire or avail any services for a consideration. It shows clearly that the auditors who render services are subjected to the provisions of the Act. Besides the applicability of the Act to the professional accountants was clearly established by the **State Forum of Maharashtra** when it has held that "*the chartered accountants are amenable to the Consumer Protection Act when it is clearly established that they have given opinion or advice on payment of fees. If the opinion or the advice is clearly contrary to the explicit provisions of law and not supported by any judicial decision or textual commentary, the prayer for awarding the compensation in regard to deficiency in service can be agitated*".

From the above it is clear that as the auditors give their opinion or advice on payment of fees they come under the purview of Consumer Protection Act and if any chartered accountant gives opinion or advice contrary to the provisions of law or any opinion not supported by any judicial decisions, he may be called upon to compensate by paying damages for the loss suffered as a result of his opinion or advice.

3. Liability for Unaudited Statements

If an auditor has associated himself in the preparation of financial statements, there is every possibility of a third party to presume that he is the auditor of the company to which he had prepared financial statements and that the books of accounts were duly audited. In such an event,

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a chartered accountant becomes liable. However, to avoid such misinterpretations, the chartered accountant should be very careful while entering into a contract/agreement with a client. And such facts should be clearly stated in the letter of appointment.

3. Criminal Liabilities

1) Under the Companies Act

Under the Companies Act, 1956, the auditors are subjected to the following criminal liabilities:

1. **False Statement:** Under section 628, an auditor is liable to penalty for false statements. That is in any return, report, certificate, balance sheet, prospectus, statement or other document required under the Companies Act, any person makes a statement which is false in any material particular, knowing to be false or which omits any material fact knowing it to be material, he shall be punishable with imprisonment for a term which may extend to two years and shall also be liable to fine.

2. **Willful Default in Making the Report:** Section 233 lays down that in case of willful default in making the auditor's report or authenticating or signing a document, the auditor shall be punishable with fine, which may extend to Rs.10,000.

2) Liabilities Under the Income Tax Act, 1961

An auditor often acts as an authorised representative of his clients and attends before an Income Tax Authority or the Appellate Tribunal in connection with proceedings under the Income Tax Act, 1961. However, if an auditor has been convicted of an offence connected with any income tax proceeding or on whom a penalty has been imposed under the said Act, he is disqualified from representing an assessee.

Further if a person abets or induces in any manner another person to make and deliver to the Income Tax Authorities a false account, statement or declaration relating to any income chargeable to tax which he knows to be false or does not believe to be true he shall be liable to rigorous imprisonment under section 278 of the Income Tax Act.

Where a chartered accountant, being an authorised representative, has prepared the return filed by the assessee, he has to furnish to the Assessing Officer the particulars of accounts, statement, and other documents supplied to him by the assessee for the preparation of the return. He has also to submit a report on the scope and results of such examination. If this report contains any information which is false and which the chartered accountant knows or believes to be false or untrue, he would be liable to rigorous imprisonment which may extend to seven years, and to fine (Rule 12A of Income Tex Rules and Sec. 277 of the Income Tax Act, 1961).

3) The Indian Penal Code

Apart from the specific criminal liabilities under the Companies Act, 1956and the Income Tax Act, 1961 discussed earlier, a chartered accountant is also liable under the Indian Penal Code for frauds, for information, etc. Section 177 of the Indian Penal Code prescribes simple imprisonment up to six months and/or fine for furnishing false information. A false statement on oath and a false declaration may attract the provisions of section 188 and 199 respectively of the Indian Penal Code. Section 193 of the Code prescribes imprisonment up to seven years and fine for giving false evidence in judicial proceedings. Under section 107, abetment of the various acts covered above attracts the same penalty.

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4. Professional Misconduct

The Chartered Accountants Act, 1949, specifies a number of acts and omissions that constitute professional misconduct in relation to Chartered Accountants in practice. The Council of ICAI may, after giving a hearing to the erring member, reprimand him or remove his name from the register of members. Similarly, the Cost and Works Accountants Act, 1959, contains provisions regarding professional misconduct in relation to cost accountants in practice. The aforesaid Act also contains provisions regarding misconduct in relation to chartered/cost accounts not in practice, as well as provisions applicable to chartered/cost accountants generally.

Section 22 of the Chartered Accountants Act defines the expression professional misconduct as deemed to be including any act or omission specified in any of the Schedules to the Act. The First and the Second Schedules to the Act contain a list of circumstances in which a chartered accountant is deemed to be guilty of professional misconduct. However, the Council of ICAI is empowered to inquire into the conduct of a chartered accountant under other circumstances also. Thus, the circumstances listed in the First and the Second Schedules to the Act are not exhaustive.

Similarly, sections 21, 22 and 33 of the Cost and Works Accountants Act define misconduct and lay down the procedures of inquiry and appeal in cases relating to misconduct by cost accountants. These provisions are similar to the provisions of sections 21, 22 and 22A of the Chartered Accountants Act.

RELIEFS AND REMEDIES TO THE COMPANY AUDITOR

So far we have discussed the liabilities of an auditor under various legislations. However, where an auditor is found technically guilty, but if he proves that he had acted honestly and reasonably, the Court may relieve him in certain cases. Further, in cases where the Court finds an auditor not guilty of negligence, default, misfeasance, etc., the company may compensate the auditor for any liability incurred by him in defending such proceedings. However, if the Articles of Association of the company or an agreement entered into by the auditor and the company or any other instruments indemnify an auditor against legal liability for negligence, default, misfeasance, breach of contract etc, they become void and the auditor cannot escape from liability.

REVIEW QUESTIONS

Part - A

1. To whom an auditor is liable for negligence while discharging his duties?
2. State the liabilities of an auditor?
3. What do you mean by negligence?
4. What damages arise out of negligence?
5. What do you mean by professional misconduct of an auditor?

Part - B

1. Summarise briefly the civil liabilities of an auditor under the Companies Act.
2. Give a brief note on auditor's criminal liabilities under the Companies Act.
3. Discuss the specific statutory liabilities of a company auditor.

Part - C

1. Discuss briefly the liabilities of a company auditor.
2. What is negligence? Discuss the liabilities of a company auditor on account of negligence.

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Share Capital and Share Transfer Audit are integral parts of corporate governance and financial control. They ensure that a company is properly managing its share capital, and that share transfers are done according to legal and regulatory guidelines. Let's break them down:

1. Share Capital Audit:

Share capital refers to the funds raised by a company in exchange for shares of stock. The **share capital audit** focuses on ensuring that a company's share capital is accurately recorded and reported, in line with the law. This audit ensures compliance with company regulations, accounting standards, and shareholder agreements.

Key Aspects of a Share Capital Audit:

- **Verification of Issued Capital:**
  The auditor verifies the number and value of shares issued and confirms that the capital raised matches what is reflected in the company's financial records.
- **Review of Shareholder Records:**
  This involves confirming that the register of shareholders is complete and up-to-date. Auditors check if the shares have been properly issued and recorded.
- **Share Classes:**
  If a company has different classes of shares (e.g., common, preferred), auditors will ensure that the rights and privileges attached to each class are properly reflected in the records.
- **Compliance with Regulatory Requirements:**
  The auditor checks whether the company's share capital complies with local regulations, such as the Companies Act or Securities laws, particularly regarding minimum capital requirements, authorized share capital, and procedures for issuing new shares.
- **Verification of Transactions:**
  Auditors examine transactions related to the issue of shares (e.g., new issues, share buybacks, capital reduction) to ensure they are properly authorized and recorded.
- **Valuation of Shares:**
  In cases where shares are issued at a price other than par (face) value, auditors verify that the valuation is fair and in line with regulatory requirements.

2. Share Transfer Audit:

Share transfer audit involves reviewing the process of transferring shares between individuals or entities to ensure that it's done correctly and in compliance with company policies and laws.

Key Aspects of Share Transfer Audit:

- **Review of Transfer Process:**
  The auditor verifies that the company's processes for transferring shares are in line with its Articles of Association, legal requirements, and shareholder agreements. This includes checking if transfer forms are properly completed, signed, and authorized.

- **Share Transfer Register:**
  This register tracks every transfer of shares within the company. Auditors ensure that this register is accurate and reflects all share transfers, including the transferor (seller) and transferee (buyer) details.
- **Transfer Approval:**
  The audit reviews whether the share transfer has been approved by the board of directors or in accordance with the Articles of Association, which might require certain approvals before a transfer can take place.
- **Compliance with Legal & Regulatory Framework:**
  Share transfers must comply with local laws and regulations. The auditor ensures that the transfer process is consistent with statutory rules (e.g., Companies Act, securities regulations).
- **Stamp Duty and Tax Compliance:**
  In some jurisdictions, stamp duty is payable on share transfers. Auditors check whether the necessary taxes are paid and whether all relevant forms and filings have been completed.
- **Documentation:**
  The auditor verifies that all necessary documentation is available for review, such as share transfer forms, board resolutions, and shareholder approvals.
- **Restrictions on Transferability:**
  If the company's Articles of Association or other agreements place restrictions on the transfer of shares (e.g., right of first refusal), the auditor ensures that such restrictions are properly applied.

Key Objectives of Share Capital and Share Transfer Audits:

- To ensure that all share capital transactions are recorded properly and reflect the actual ownership structure.
- To verify that share transfers occur in accordance with legal and regulatory requirements.
- To safeguard the interests of shareholders by ensuring transparency and fairness in the process.
- To detect any potential irregularities, fraud, or mismanagement in the issuance and transfer of shares.
- To ensure that all applicable taxes (e.g., stamp duty) are paid and compliance with tax laws is maintained.

Audit Report

An **Audit Report** is a formal opinion or disclaimer issued by an independent auditor after reviewing a company’s financial records and operations. It is an essential document in corporate governance and financial transparency, providing stakeholders (such as shareholders, investors, regulators, and management) with an assurance regarding the accuracy and fairness of a company's financial statements.

Structure of an Audit Report:

An audit report generally follows a standard format, but specific components might vary depending on the audit type, legal requirements, and the auditing standards followed (e.g., **International Standards on Auditing (ISA)** or **Generally Accepted Auditing Standards (GAAS)**). Here's the typical structure of an **audit report**:

1. **Title of the Report:**
    - This usually includes the words "Independent Auditor's Report" to emphasize the auditor's independent role.
2. **Addressee:**
    - The report is addressed to the company's stakeholders—typically the shareholders, board of directors, or other appropriate entities.
3. **Introduction/Opening Paragraph:**
    - **Company Information:** The audit report starts by stating the name of the company, the period under review, and the financial statements being audited.
    - **Management's Responsibility:** It clarifies that the company's management is responsible for preparing and presenting the financial statements.
    - **Auditor's Responsibility:** It outlines the auditor's responsibility to express an opinion on the financial statements based on the audit.

    Example:

    > "We have audited the financial statements of [Company Name] for the year ended [Date], which comprise the balance sheet as of [date], the profit and loss statement, the cash flow statement, and the notes to the financial statements, including a summary of significant accounting policies."

4. **Scope of the Audit:**
    - This section explains the methodology used to perform the audit, specifying whether the auditor has followed a particular set of auditing standards (such as ISA or GAAS).
    - It highlights the audit process (such as reviewing records, testing internal controls, and assessing the overall financial health of the company).
    - The auditor also states if they believe they have gathered sufficient and appropriate evidence to provide an opinion on the financial statements.

    Example:

    > "Our audit was conducted in accordance with International Standards on Auditing (ISA). We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion."

5. **Audit Opinion:**
    - This is the core part of the audit report where the auditor expresses their opinion on the financial statements. The opinion can be one of the following:

- **Unqualified Opinion (Clean Opinion):**
  The auditor believes the financial statements are fairly presented in all material respects, following applicable accounting standards.
  - Example: *"In our opinion, the financial statements present a true and fair view of the company's financial position as of [date] and its performance and cash flows for the year then ended, in accordance with [Accounting Standard] and the Companies Act [year]."*
- **Qualified Opinion:**
  The auditor agrees with most of the financial statements but believes there are certain areas where the statements do not fully comply with applicable accounting principles.
  - Example: *"In our opinion, except for the effects of the matter described in the basis for qualification paragraph, the financial statements present fairly the company's financial position."*
- **Adverse Opinion:**
  This is given when the auditor believes the financial statements do not present a true and fair view of the company's financial situation and are materially misstated.
  - Example: *"In our opinion, because of the significance of the matter described in the basis for adverse opinion paragraph, the financial statements do not present a true and fair view of the company's financial position."*
- **Disclaimer of Opinion:**
  This opinion is issued when the auditor is unable to obtain sufficient evidence to form an opinion, or there are limitations on the scope of the audit.
  - Example: *"We do not express an opinion on the financial statements because of the matter described in the basis for disclaimer of opinion paragraph."*

6. **Basis for Opinion:**
   - This section provides details on the rationale behind the auditor's opinion, explaining any reasons for qualifications or disclaimers. This is especially relevant if the auditor issues a **qualified**, **adverse**, or **disclaimer of opinion**.

   Example (for a qualified opinion):

   "We were unable to verify the completeness of the accounts receivable balance due to the lack of adequate documentation provided by management."

7. **Emphasis of Matter (if applicable):**
   - If there are significant matters that, while not affecting the opinion, should be brought to the attention of the users of the financial statements (such as material events after the reporting period), the auditor may include an emphasis of matter paragraph.

Example:

> "We draw attention to Note X to the financial statements, which describes the significant impact of the global pandemic on the company's operations and financial position."

8. **Other Information (if applicable):**
   - If the audit report includes other information outside the financial statements (e.g., in the annual report), the auditor may review this information for consistency with the financial statements. However, the auditor does not provide an opinion on it unless it's related to the financial statements.
9. **Auditor's Signature and Details:**
   - The audit report concludes with the signature of the lead auditor or the auditing firm. This section includes the auditor's name, designation (e.g., Chartered Accountant, Auditor), and the name of the audit firm.
10. **Date of the Report:**
    - The date the audit report is finalized is included. It should correspond to the date the audit fieldwork was completed.
11. **Auditor's Address:**
    - In some jurisdictions, the auditor's address or the location where the audit firm is based may be included.

Example of an Audit Report:

Independent Auditor's Report

To the Shareholders of [Company Name]

Report on the Audit of the Financial Statements

We have audited the financial statements of [Company Name] for the year ended [Date], which comprise the balance sheet as of [date], the profit and loss statement, the statement of cash flows, and the notes to the financial statements, including a summary of significant accounting policies.

Management's Responsibility for the Financial Statements
The management is responsible for the preparation and fair presentation of these financial statements in accordance with [applicable accounting standards], and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with [relevant auditing standards]. Those standards require

that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

In conducting our audit, we have followed the standard audit procedures to gather sufficient and appropriate audit evidence to support our audit opinion.

Opinion
In our opinion, the financial statements present a true and fair view of the financial position of [Company Name] as of [date], and its financial performance and cash flows for the year then ended, in accordance with [applicable accounting standards].

Basis for Opinion
We have obtained all the information and explanations that we considered necessary for the purposes of our audit. The audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Emphasis of Matter
We draw attention to Note X to the financial statements, which discusses the potential impact of changes in the regulatory environment on the company's financial performance.

Signature of Auditor
[Auditor Name]
[Audit Firm Name]
[City, Date]

Contents of an Audit Report:

The content of an audit report can vary slightly depending on the auditing standards followed (e.g., **International Standards on Auditing (ISA)** or **Generally Accepted Auditing Standards (GAAS)**), but it generally includes the following key components:

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1. Title of the Report:

- The title typically includes the phrase "**Independent Auditor's Report**" to indicate the independence of the auditor.

2. Addressee:

- The report is addressed to the shareholders, board of directors, or other relevant stakeholders of the company being audited.

3. Introduction:

- **Identification of the company**: The name of the company whose financial statements are being audited.
- **Financial period**: The period for which the financial statements are being audited (usually for the fiscal year).
- **Financial statements covered**: A reference to the financial statements that have been audited, such as the **balance sheet**, **profit and loss statement**, **cash flow statement**, and any related notes to the financial statements.

Example:

"We have audited the financial statements of XYZ Ltd for the year ended [Date], which comprise the balance sheet, the statement of profit and loss, and the statement of cash flows, along with the notes to the financial statements."

4. Management's Responsibility:

- A statement explaining that the responsibility for the preparation and presentation of the financial statements lies with the company's management. This section also includes management's responsibility for ensuring that the financial statements are free from material misstatement, whether due to fraud or error.

Example:

"Management is responsible for the preparation and fair presentation of these financial statements in accordance with [Applicable Accounting Standards], and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error."

5. Auditor's Responsibility:

- A description of the auditor's role in reviewing and providing an opinion on the company's financial statements. It outlines the auditor's responsibilities to obtain reasonable assurance that the financial statements are free of material misstatements and to express an opinion based on the audit findings.

Example:

"Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with [relevant auditing standards], which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement."

6. Scope of the Audit:

- The auditor explains the procedures they used during the audit, which include inspecting financial records, evaluating internal controls, and testing transactions. This section may also note if any limitations were encountered during the audit process.

Example:

"Our audit was conducted in accordance with [International Standards on Auditing (ISA) or GAAS], which require us to comply with ethical requirements and to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement."

7. Audit Opinion:

- The **audit opinion** is the key conclusion of the report, where the auditor expresses their professional opinion on the truth and fairness of the financial statements. There are different types of opinions, which will be covered in more detail below.

Example:

"In our opinion, the financial statements present a true and fair view of the financial position of XYZ Ltd as of [date] and its financial performance and cash flows for the year then ended, in accordance with [Applicable Accounting Standards]."

8. Basis for Opinion:

- If the auditor's opinion is unqualified (clean opinion), this section briefly explains that the audit evidence obtained is sufficient to form the basis for the opinion. In case of a **qualified**, **adverse**, or **disclaimer** of opinion, the auditor will explain the reasons for the qualification.

Example:

"We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion."

9. Emphasis of Matter (if applicable):

- If there are any significant issues or areas of concern (e.g., uncertainties or material events after the reporting period), the auditor will emphasize these matters. However, an **Emphasis of Matter** does not alter the audit opinion.

Example:

"We draw attention to Note X, which discusses the potential impact of the current global pandemic on the company's operations and financial position."

10. Other Information (if applicable):

- This section covers any other relevant information provided outside the financial statements, such as in the company's annual report or other documents. The auditor will review this information for consistency with the audited financial statements.

11. Signature of Auditor:

- The auditor or audit firm's name and the signature of the lead auditor appear here.

12. Date of the Report:

- The report is dated when the audit is concluded and the auditor is satisfied that they have gathered sufficient evidence.

13. Auditor's Address:

- In some jurisdictions, the auditor's address or the location where the audit firm is based may be included.

Types of Audit Reports:

There are four primary types of audit opinions that auditors can issue in their reports, depending on the outcome of the audit:

1. Unqualified Opinion (Clean Opinion):

- **Definition**: This is the best and most favorable opinion an auditor can give. It means the auditor believes the financial statements are presented fairly and in accordance with the applicable accounting standards.
- **When Issued**: Issued when the auditor finds no material misstatements and believes the financial statements provide a true and fair view of the company's financial position and performance.

Example Opinion:

"In our opinion, the financial statements present a true and fair view of the company's financial position and performance in accordance with [Applicable Accounting Standards]."

2. Qualified Opinion:

- **Definition**: A qualified opinion is issued when the auditor finds issues with the financial statements, but the problems are not so pervasive that they would affect the entire financial report. This means the auditor is almost satisfied with the statements, except for certain areas.
- **When Issued**: When the auditor identifies areas where the financial statements do not fully comply with accounting standards but where the misstatements are not material enough to alter the entire financial picture.

Example Opinion:

"In our opinion, except for the effects of the matter described in the Basis for Opinion paragraph, the financial statements present a true and fair view of the company's financial position."

3. Adverse Opinion:

- **Definition**: An adverse opinion is issued when the auditor believes the financial statements are materially misstated and do not present a true and fair view of the company's financial position.
- **When Issued**: Issued when the auditor finds significant misstatements or deviations from accounting standards that are pervasive and undermine the entire financial report.

Example Opinion:

"In our opinion, because of the significance of the matters described in the Basis for Opinion paragraph, the financial statements do not present a true and fair view of the company's financial position."

4. Disclaimer of Opinion:

- **Definition**: A disclaimer of opinion is issued when the auditor is unable to obtain sufficient evidence to form an opinion on the financial statements. This could be due to limitations in scope, missing documents, or other factors that prevent the auditor from performing a full audit.
- **When Issued**: Issued when there are limitations that prevent the auditor from obtaining sufficient evidence to form an opinion, or if the auditor believes they cannot express an opinion on the financial statements.

Example Opinion:

"We do not express an opinion on the financial statements because of the matter described in the Basis for Disclaimer of Opinion paragraph."

UNIT - V

Investigation

Meaning

Investigation generally refers to a **systematic process** of inquiry or examination to uncover facts, gather evidence, or understand a situation or problem. The purpose of an investigation is often to determine the **truth**, identify the cause of a particular event, or assess a specific issue by collecting relevant information. Investigations are carried out in various contexts, such as legal, criminal, corporate, scientific, or journalistic fields.

1. Establish the Facts

- **Objective**: The primary goal of any investigation is to uncover and establish the **facts** of the matter being investigated. This could involve identifying the truth about an event, situation, or activity.
- **Example**: In a criminal investigation, the goal would be to determine what happened, when it happened, and who was involved.
- **Importance**: Establishing facts provides a foundation for decision-making and actions.

2. Identify the Cause(s)

- **Objective**: To understand the **root causes** or **contributing factors** behind an event, issue, or problem. This is especially critical in investigative fields like **accident investigations** or **fraud detection**.
- **Example**: A corporate investigation into financial discrepancies may seek to identify the cause of accounting errors or fraud—whether it was due to negligence, system failures, or intentional misconduct.
- **Importance**: Identifying causes helps in taking corrective action to prevent recurrence and improve processes.

3. Determine Responsibility or Accountability

- **Objective**: One of the most important objectives of an investigation is to **assign responsibility** or **accountability**. This could involve determining who is at fault, whether through intentional wrongdoing or inadvertent action.
- **Example**: In a workplace investigation involving harassment allegations, the investigator's objective would be to determine who is responsible for the inappropriate behavior.
- **Importance**: Holding individuals or organizations accountable is essential for ensuring justice, fairness, and adherence to laws or company policies.

4. Uncover Evidence

- **Objective**: The investigation aims to **gather relevant evidence** that supports or disproves claims, allegations, or suspicions. This could include physical evidence, documents, testimonies, or digital data.
- **Example**: In a criminal investigation, gathering forensic evidence (fingerprints, DNA, security footage) is crucial to solving the case.
- **Importance**: Evidence is the cornerstone of most investigations, as it helps establish facts and provide proof to support findings.

5. Preserve Integrity and Objectivity

- **Objective**: To ensure that the investigation is **objective, unbiased, and fair**. Investigators must gather and analyze facts without any preconceived notions, personal bias, or external pressure.
- **Example**: In a workplace misconduct investigation, maintaining objectivity ensures that both the accused and the accuser are treated fairly, with no prejudice influencing the findings.
- **Importance**: Objectivity ensures that the findings of the investigation are credible and trustworthy, and that the process remains lawful and ethical.

6. Protect Legal Rights and Interests

- **Objective**: In many types of investigations (especially criminal or regulatory), an essential objective is to **protect the legal rights** of all involved parties (such as the right to a fair trial, privacy, or protection from self-incrimination).
- **Example**: During a corporate investigation into fraud, investigators must protect the confidentiality of sensitive information and adhere to legal protocols such as data protection regulations.
- **Importance**: Protecting legal rights ensures that the investigation complies with laws and that the outcome is legally sound, reducing the risk of legal challenges or injustice.

7. Prevent Future Occurrences

- **Objective**: An investigation often aims to identify weaknesses or gaps in processes, systems, or behavior that led to the issue. By identifying these gaps, the investigation seeks to recommend actions that can **prevent similar events from happening again**.
- **Example**: After a workplace accident, an investigation might uncover safety violations or insufficient training and recommend policy changes or new safety protocols to prevent future incidents.
- **Importance**: Preventing recurrence not only resolves the current issue but also strengthens the organization's overall processes and reduces risks in the future.

8. Ensure Compliance with Laws, Policies, or Regulations

- **Objective**: In regulatory, corporate, or legal investigations, one of the objectives is to ensure that all activities are in **compliance** with applicable laws, standards, regulations, or organizational policies.
- **Example**: A financial investigation may aim to determine whether a company has complied with tax laws, accounting standards, or internal control policies.
- **Importance**: Ensuring compliance helps mitigate legal risks, avoid penalties, and safeguard an organization's reputation.

9. Provide Recommendations for Corrective or Disciplinary Action

- **Objective**: Based on the findings, the investigation should provide clear **recommendations** for corrective actions, improvements, or disciplinary measures.
- **Example**: In an internal audit investigation, recommendations might include implementing tighter financial controls, additional training, or disciplinary action against those found responsible for fraud.
- **Importance**: Recommendations help address the issue at hand and offer a path forward to resolve the matter and prevent recurrence.

10. Clarify the Situation and Resolve Uncertainty

- **Objective**: Investigations can help **clarify uncertainties** or **dispel doubts** about an issue, event, or individual. This is especially important when there are conflicting reports or widespread rumors.
- **Example**: A media investigation into a public scandal might seek to clarify the facts and present the truth to the public, resolving confusion and misinformation.
- **Importance**: Resolving uncertainty helps reduce rumors, restore trust, and create a clear understanding of the situation.

Audit of Computerized Accounts refers to the process of reviewing and examining the financial transactions, records, and systems maintained through computer software or digital platforms to ensure accuracy, reliability, and compliance with accounting standards and legal requirements. As businesses increasingly adopt automated systems for accounting and financial reporting, auditing computerized accounts becomes crucial to detect errors, fraud, and inefficiencies.

Key Objectives of Auditing Computerized Accounts:

1. **Ensure Accuracy of Financial Data**:
    - The audit aims to verify that the financial data entered into the computerized system is accurate, complete, and free from errors.
2. **Test the Reliability of Automated Controls**:

- Computerized systems often have built-in internal controls (e.g., validation checks, authorization limits, and automated reporting). The auditor assesses these controls to ensure that they are functioning properly and effectively safeguard against errors or fraud.

3. **Evaluate the System's Integrity**:
   - This involves ensuring that the system's data has not been tampered with and that proper backups and recovery mechanisms are in place.
4. **Assess Compliance with Regulations**:
   - Ensure that the computerized system complies with relevant financial reporting standards (such as IFRS or GAAP) and regulatory requirements (such as tax laws).
5. **Assess Internal Controls**:
   - Auditors review internal controls embedded within the system (such as password protection, access restrictions, audit trails, and system security) to ensure that the financial data is protected from unauthorized access or manipulation.
6. **Ensure Proper Access and Segregation of Duties**:
   - The audit checks if the system ensures proper segregation of duties (e.g., ensuring that the person who records transactions is not the same as the one who authorizes payments) and that only authorized personnel have access to sensitive financial information.

Steps in Auditing Computerized Accounts:

1. **Understand the Computerized System and Software**:
   - The auditor first gains an understanding of the software or accounting system used by the organization. This includes understanding the system's architecture, features, and how it integrates with other business processes.
   - Common accounting software used by businesses includes **QuickBooks**, **SAP**, **Oracle Financials**, **Tally**, **Xero**, and others.
2. **Review of System Controls**:
   - The auditor evaluates the **automated internal controls** in place within the system, such as:
     - **Access Control**: Restricting access to financial data to authorized users only.
     - **Authorization**: Ensuring that transactions are authorized by the appropriate personnel.
     - **Audit Trail**: Verifying that the system logs and records all changes, allowing for tracking of who made changes to the financial data.
     - **Backup and Recovery**: Ensuring regular backups are performed and can be restored in case of system failures or data loss.
     - **Data Integrity Checks**: Ensuring that the system automatically flags discrepancies, such as unbalanced trial balances, duplicate entries, or errors in data entry.
3. **Evaluate the Accuracy of Data Entry and Processing**:
   - The auditor tests a sample of transactions entered into the system to verify their accuracy. This may include:

        - Cross-checking accounting entries against source documents (invoices, receipts, bank statements).
        - Verifying that transactions are processed correctly, such as the correct amounts, accounts, and classifications.
4. **Test the Output Generated by the System**:
    - The auditor reviews key financial reports and statements generated by the system (e.g., balance sheets, profit & loss statements, cash flow statements) to ensure they are accurate and comply with applicable accounting standards.
5. **Examine Data Backup and Recovery Procedures**:
    - Ensuring that the business has appropriate backup procedures for the computerized accounts. The auditor may test whether the backups are reliable, up-to-date, and can be restored as needed.
6. **Security and Fraud Detection**:
    - Auditors assess the security of the accounting system to prevent unauthorized access or data breaches. They may test for vulnerabilities and evaluate if there are measures in place to detect fraudulent activities (e.g., unauthorized changes, fraudulent transactions).
7. **Review Segregation of Duties**:
    - The auditor checks whether proper **segregation of duties** is in place within the computerized system to prevent a single individual from controlling all aspects of the financial process (e.g., recording and authorizing transactions).
8. **Verify Compliance with Laws and Regulations**:
    - The auditor ensures that the system is compliant with financial reporting regulations, taxation laws, and any other relevant legal requirements. This may involve reviewing automated tax calculations or compliance with local financial reporting standards.
9. **Test Period-End Procedures**:
    - The auditor tests the system's ability to handle period-end procedures, such as closing the books, generating year-end reports, and ensuring that the financial data for each period is correctly handled and archived.
10. **Conduct Analytical Procedures**:
    - The auditor may use **analytical procedures** to analyze the financial statements generated by the system. This involves comparing ratios, trends, and key performance indicators (KPIs) against historical data, industry benchmarks, or expectations to identify unusual trends or anomalies.

Challenges in Auditing Computerized Accounts:

1. **Complexity of Software Systems**:
    - The more complex the software, the harder it is for the auditor to understand its functionality fully. For example, **enterprise resource planning (ERP)** systems like **SAP** have various modules for different business functions, making it harder to trace transactions.

2. **Data Privacy and Security**:
    - As systems become more interconnected, ensuring that financial data is securely handled becomes more difficult. The auditor must evaluate the system's security to prevent unauthorized access or data breaches.
3. **Lack of Manual Controls**:
    - Many manual controls are automated in computerized systems. This can lead to challenges in detecting fraud or errors, especially if the system's design does not adequately reflect the company's internal control framework.
4. **Audit Trail Verification**:
    - In computerized systems, it may be challenging to track changes in financial data if audit trails are not properly configured or maintained. The auditor needs to ensure that every change is logged and traceable.
5. **Dependence on System Configuration**:
    - The accuracy of financial reporting depends on how the system is configured. If there are errors in how the system is set up (e.g., incorrect chart of accounts or tax rates), it could affect the entire financial reporting process.

Tools and Techniques Used in Auditing Computerized Accounts**:**

1. **Data Analytics**:
    - Auditors use data analysis tools and techniques to analyze large volumes of financial data. These tools can help identify anomalies, trends, and outliers that may require further investigation.
2. **Generalized Audit Software (GAS)**:
    - GAS tools, like **ACL** or **IDEA**, allow auditors to test data, extract samples, perform reconciliations, and create customized reports directly from computerized records.
3. **Computer-Assisted Audit Techniques (CAATs)**:
    - CAATs involve using specialized software to access, analyze, and test financial data directly from the system without manually reviewing the records. These techniques help in performing tasks like transaction testing, data mining, and risk assessments.

Electronics Auditing typically refers to the process of auditing electronic systems, devices, and components used in various industries, particularly in the fields of **electronics manufacturing, repair, and development**, to ensure compliance with regulatory standards, safety, and quality standards. This type of audit can also extend to **electronic data systems**, such as financial or business information managed through digital systems.

Key Areas of Electronics Auditing:

1. **Product Auditing in Electronics Manufacturing**:
    - This involves reviewing the manufacturing process, the components used in the production of electronic devices (such as **circuit boards**, **microchips**, **sensors**, and **power supplies**), and the final products to ensure they meet industry standards (e.g., **ISO standards**, **CE marking**, **RoHS compliance**).

- **Key Objectives**:
  - **Quality Control**: Ensuring that electronic products meet quality standards, are free from defects, and function as intended.
  - **Safety Standards Compliance**: Checking if the products comply with safety regulations like **UL (Underwriters Laboratories)** standards or **IEC (International Electrotechnical Commission)** standards.
  - **Environmental Standards Compliance**: Ensuring that products meet **RoHS (Restriction of Hazardous Substances)** regulations, which restrict the use of certain hazardous materials in electrical and electronic products.

2. **Environmental Impact Auditing of Electronics**:
   - Electronic waste (e-waste) has become a significant concern due to the rapid turnover of electronic devices and their disposal. An **electronics environmental audit** focuses on assessing the environmental impact of electronic products throughout their life cycle—from manufacturing to disposal.
   - **Key Objectives**:
     - **E-waste Management**: Ensuring that manufacturers and consumers handle electronic waste responsibly.
     - **Energy Consumption and Efficiency**: Reviewing whether the product designs prioritize energy efficiency and contribute to sustainable practices.
     - **Compliance with Environmental Laws**: Ensuring compliance with environmental laws related to manufacturing processes and disposal, such as **WEEE (Waste Electrical and Electronic Equipment Directive)** in the EU.
3. **Audit of Electronic Data Systems**:
   - In organizations, electronic data systems (like **enterprise resource planning (ERP)** software, **financial accounting systems**, **customer databases**, etc.) need to be audited to ensure the integrity, security, and reliability of electronic records and transactions.
   - **Key Objectives**:
     - **Data Integrity**: Ensuring that data stored in the system is accurate, complete, and up-to-date.
     - **Access Control and Security**: Verifying that only authorized personnel can access sensitive or confidential data, using proper authentication and encryption.
     - **Compliance with Regulatory Standards**: Checking that the system adheres to relevant data protection and financial reporting standards (e.g., **GDPR**, **SOX**, **HIPAA**).
4. **Electronics in Consumer Goods**:
   - Products such as **smartphones**, **laptops**, **televisions**, **home appliances**, and **wearable tech** are constantly evolving. Electronics auditing for consumer goods focuses on ensuring the quality and safety of these products, as well as their adherence to **international quality standards**.
   - **Key Objectives**:
     - **Testing and Certification**: Products must pass rigorous **testing** for safety, performance, and compatibility, ensuring they meet national or international standards.

        - **Product Recall Audits**: Auditing the processes for recalling defective or unsafe products from the market.
5. **Electronics Supply Chain Auditing**:
    - This area focuses on the **supply chain of electronics**, from the procurement of raw materials (e.g., metals for semiconductors) to the delivery of finished products. The audit aims to assess the **quality control**, **cost control**, **sustainability**, and **ethical sourcing** in the supply chain.
    - **Key Objectives**:
        - **Supplier Compliance**: Ensuring that suppliers of electronic components meet safety and environmental standards.
        - **Ethical Sourcing**: Verifying that the materials and components used in electronics are sourced ethically and responsibly (e.g., ensuring no use of conflict minerals).
        - **Cost Efficiency**: Auditing the supply chain for cost control and ensuring efficient logistics and sourcing of components.

Components of an Electronics Audit:

1. **Inspection of Materials**:
    - An auditor reviews the raw materials used in the production of electronic components, ensuring they meet required standards. For example, for **semiconductors**, the purity of the silicon used is critical.
2. **Manufacturing Process**:
    - Auditors check the production lines to verify that the manufacturing processes are efficient, safe, and compliant with industry standards.
    - **Automated and Manual Checks**: Electronic products often require manual and automated quality control checks throughout production, such as **visual inspection**, **functionality tests**, and **stress testing**.
3. **Testing of Finished Products**:
    - **Functionality Testing**: Products are tested for proper functionality, whether it's a **smartphone**, **TV**, or **microcontroller**. This includes checking if the product performs as expected in terms of usability, connectivity, and safety.
    - **Environmental Testing**: Products are often subjected to stress tests for durability, including high/low-temperature exposure, **moisture resistance**, and **shock resistance**.
    - **Safety Testing**: Ensuring compliance with safety regulations such as **CE marking** or **UL testing**, which certifies that the product is safe for consumer use.
4. **Compliance Auditing**:
    - The auditor assesses whether the manufacturing processes comply with local and international regulations, such as:
        - **RoHS** (restricting hazardous substances in electronic products)
        - **WEEE** (Waste Electrical and Electronic Equipment Directive)
        - **Energy Star** (energy efficiency in electronics)
        - **ISO 9001** (quality management systems)
        - **ISO 14001** (environmental management systems)

5. **Supply Chain Auditing**:
    - The electronics audit often involves reviewing the entire supply chain, ensuring that suppliers are providing the required quality of components and that there is no unethical sourcing or labor practices.
6. **Verification of Documentation**:
    - The audit also includes checking that all the relevant documentation for components, processes, and certifications is accurate and complete. This is vital for product traceability and accountability.
7. **Security and Software Auditing**:
    - For **smart devices** or products with embedded software (like **smart TVs** or **IoT devices**), auditors review the security features and ensure that the devices cannot be easily hacked or misused. This might involve:
        - Penetration testing for cybersecurity vulnerabilities.
        - Reviewing the software for proper updates and patching.
        - Ensuring that the product complies with **privacy** regulations (e.g., GDPR).

Types of Electronics Audits:

1. **Compliance Audit**:
    - Ensures that electronics manufacturing or data systems adhere to legal and industry standards (e.g., environmental, safety, quality).
2. **Quality Audit**:
    - Focuses on the overall quality management system in the production or development of electronic devices. This audit ensures that products are being manufactured to meet required standards, specifications, and performance criteria.
3. **Environmental Audit**:
    - Assesses the environmental impact of manufacturing processes and the lifecycle of electronic products, with an emphasis on compliance with **RoHS**, **WEEE**, or other environmental standards.
4. **Cybersecurity Audit**:
    - For electronic devices with software and networking capabilities, a **cybersecurity audit** examines how secure the devices are against hacking, data breaches, and unauthorized access.
5. **Supply Chain Audit**:
    - Reviews the supply chain for ethical practices, quality control, and regulatory compliance, ensuring that all components used in electronics manufacturing meet required standards.
6. **Energy Efficiency Audit**:
    - Focuses on the energy consumption of electronic devices and products, ensuring they meet energy efficiency standards, such as **Energy Star** certification.

Benefits of Electronics Auditing:

- **Ensures Compliance**: Helps manufacturers comply with regulatory standards for safety, quality, and environmental impact.
- **Improves Quality**: Auditing identifies areas of improvement in manufacturing processes, leading to higher product quality and fewer defects.
- **Prevents Fraud and Errors**: Regular audits help identify issues in design, production, or security that could lead to fraud or technical failures.
- **Protects Reputation**: By ensuring compliance and product quality, businesses protect their brand reputation and avoid legal liabilities.
- **Reduces Costs**: By identifying inefficiencies in production, energy consumption, and the supply chain, audits can help reduce operational costs.

Key Areas of Investigation Under the Companies Act

1. Financial Mismanagement:

- An investigation under the Companies Act may focus on fraudulent financial practices such as:
    - **Misappropriation of funds**.
    - **Falsification of accounts**.
    - **Non-disclosure of liabilities** or **assets**.
    - **Incorrect reporting** in financial statements (e.g., false profits, underreporting debts).

2. Fraudulent Activities:

- Fraudulent activities such as:
    - **Misrepresentation of financial position**.
    - **Insolvency fraud** (where the company deliberately hides its financial instability).
    - **Cheque fraud** or **embezzlement**.

3. Compliance Violations:

- Failure to comply with regulatory frameworks, such as:
    - Non-compliance with **filing requirements** (e.g., annual reports, board resolutions, etc.).
    - **Non-compliance with corporate governance** norms.
    - Failure to disclose conflicts of interest or related-party transactions.

4. Director/Management Misconduct:

- Mismanagement or misconduct by the company's **directors** or **key officers**. This could involve:

- **Failure to act in the best interest of shareholders**.
- **Conflict of interest** or **self-dealing**.
- **Breach of fiduciary duties**.

5. Regulatory and Tax Evasion:

- Investigating the company's activities for possible **tax evasion**, **GST fraud**, or **non-compliance** with other regulatory requirements like labor laws, environmental standards, etc.

Process of Investigation Under the Companies Act:

1. **Initiation of Investigation**:
   - The process starts when a request for investigation is filed with the Registrar of Companies (RoC) or the Central Government. This request can be made by shareholders, creditors, or government authorities based on reasonable grounds.
2. **Appointment of Inspector**:
   - Upon receiving the request, the Central Government appoints an **Inspector** (often an independent party with expertise in corporate law and auditing) to conduct the investigation.
3. **Examination of Records**:
   - The inspector reviews the company's financial records, documents, accounting books, and any other related information. The inspector may also summon key officials (such as directors, managers, or auditors) for questioning.
4. **Investigation Report**:
   - After completing the investigation, the inspector submits a report with findings. This report can recommend:
     - **Further legal action** (civil or criminal).
     - **Penalties or fines**.
     - **Corporate governance reforms**.
5. **Follow-up Actions**:
   - Based on the investigation report, the government or other regulatory bodies can initiate follow-up actions like prosecution, regulatory penalties, or corrective actions.

Consequences of a Company Investigation:

1. **Fines and Penalties**:
   - If the investigation reveals violations, the company or its officers may face **fines**, **penalties**, or **compensation claims**.
2. **Management Changes**:
   - The company may be forced to remove directors or managers found to be guilty of fraud or mismanagement.
3. **Criminal Liability**:
   - Serious offenses, such as financial fraud or embezzlement, can lead to criminal charges against individuals involved, and the company may face prosecution.

4. **Reputation Damage**:
    - The investigation can damage the company's reputation in the market, affecting shareholder trust and investor relations.

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