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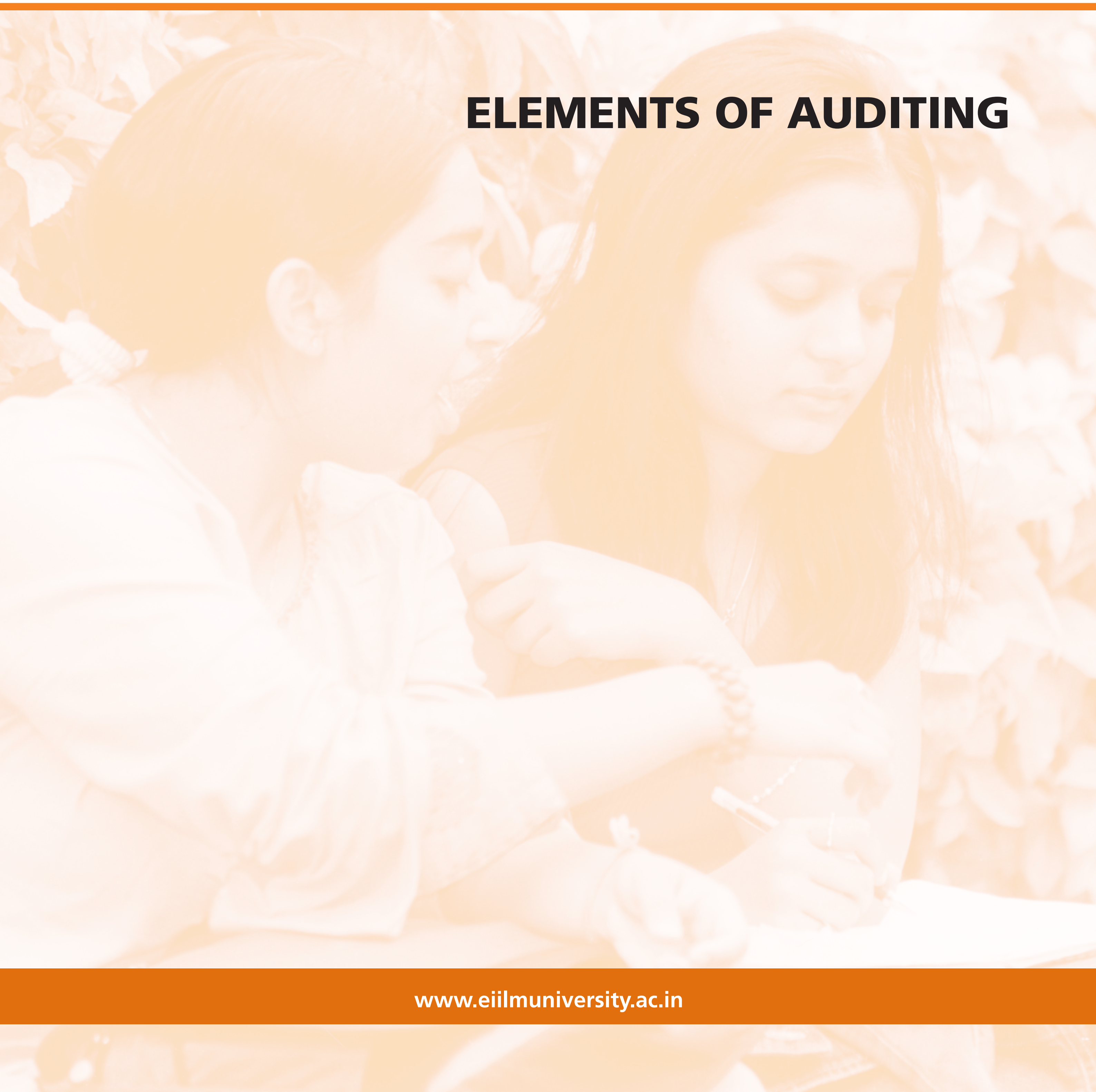
ELEMENTS OF AUDITING



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Subject: ELEMENTS OF AUDITING **Credits: 4**

SYLLABUS

Fundamentals of Auditing
Internal Control, Basic Concepts, Audit Planning

Vouching and Verification
Vouching of Trading Transactions and Impersonal Ledger, Verification and Valuation of Assets and Liabilities I, Verification and Valuation of Assets and Liabilities II, Vouching and Cash Transactions

Company Audit
Company Audit I, Company Audit II, Company Auditor

Auditor's Report and Cost Audit
Cost and Management Audit**,** Auditor's Report

Suggested Readings:

1. Aasmund Eilifsen , Steven M. Glover , William F. Messier , Douglas F. Prawitt ‘Auditing and assurance Services’, McGraw-Hill Education
2. Rick Stephan Hayes, Roger Dassen, Arnold Schilder, Philip Wallage, ‘Principles Of Auditing: An Introduction To International Standards On Auditing’, Financial Times Prentice Hall
3. John Raymond Wildman, ‘Principles of Auditing’, William G. Hewitt Press

Fundamentals of Auditing

Learning Objectives

Upon completion of this chapter you will

- Understand the concept of audit risk.
- Enumerate the features of a good internal control system.
- Know the objectives of auditing.
- Know more about suggested code of Ethics.
- Understand the fraud occuring through auditing

Chapter-1 Basic Concepts

1.1 Understanding Audits

1.2 The common group of audits covers a broad range of assessment types, most of which relate to financial issues (e.g., real estate, financial portfolio, tax-related assessments, or accounting practice business assessments). Audits are confusing processes that are defined by the relationship of the auditor to the authority requesting the assessment and the entity being audited.

Today we see the discipline of auditing under fire because some major auditing and consulting firms have shown themselves lacking in compliance with industry established ethics codes of conduct. The media is ripe with news describing the conflict generated by the consultants/auditors when they ignored the principles of their profession and advised clients to misrepresent themselves to the public. They created an inter-dependence between their customers and their firms that enriched both entities at the expense of the employees and stockholders.

Auditors are required, by the nature of their profession, to render opinions (attestations) based upon valid evidence relating to the condition of their customers' accounting practices. The auditor is liable for the accuracy of the opinion rendered. This liability is a constant reminder of the extensive responsibilities entrusted to a person identified as an auditor. Responsibilities are not to be taken lightly by people who conduct audits or desire to become auditors. A plaintiff may bring suit against an auditor under common statutory, or both common and statutory law.

Auditing is a serious discipline. Auditors must be the most experienced, knowledgeable, professionally qualified individuals in a discipline. National Property Management Association represents the greatest potential for finding individuals uniquely qualified to be auditors in the discipline of Personal Property (Asset) Management.

1.1.1 Idea

Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors.

If decisions are to be consistent with the intention of the decision makers, the information used in the decision process must be reliable. Unreliable information can cause inefficient use of resources to the detriment of the society and to the decision makers themselves. In the lending decision example, assume that the barfly makes the loan on the basis of misleading financial statements and the borrower Company is ultimately unable to repay. As a result the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money.

As society become more confusing, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this: remoteness of information, voluminous data and the existence of confusing exchange transactions. As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring him that the information is sufficiently reliable for these decisions. In doing this he must weigh the cost of obtaining more reliable information against the expected benefits.

A common way to obtain such reliable information is to have some type of verification (assessment) performed by independent persons. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased.

1.3 Origin

The term audit is derived from the Latin term 'audire,' which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them Auditing is as old as accounting. It was in use in all ancient countries such as Mesopotamia, Greece, Egypt. Rome, U.K. and India.

The Vedas contain reference to accounts and auditing. Arthasashthra by Kautilya detailed rules for accounting and auditing of public finances. The original objective of auditing was to detect and prevent errors and frauds.

Auditing evolved and grew rapidly after the industrial revolution in the 18^{th} century With the growth of the joint stock companies the ownership and management became separate. The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees.

The objective of assessment shifted and assessment was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds. In India the companies Act 1913 made assessment of company accounts compulsory

With the increase in the size of the companies and the volume of transactions the main objective of assessment shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts

The companies Act.1913 also prescribed for the first time the qualification of auditors The International Accounting Standards Committee and the Accounting Standard board of the Institute of Chartered Accountants of India have developed standard accounting and auditing practices to guide the accountants and auditors in the day to day work The later developments in auditing pertain to the use of computers in accounting and auditing.

In conclusion it can be said that auditing has come a long way from hearing of accounts to taking the help of computers to examine computerised accounts

1.3 Role of Auditing:

The demand for auditing is a result of four underlying factors:

The complexity of the system refers to the activity in an institution or business, along with the interaction of the exchanges of information, which often make the proper recording of transactions and allocations of costs difficult to track.

The physical remoteness of the system increases the likelihood both of intentional or unintentional error and of demand for an independent party to examine the records.

Bias and motives of the provider create a demand for an independent party to lend credibility to the company's financial or property system statements. For example, management may be more optimistic about the status of the property system than the

Government. The optimism may be based on accurate or inaccurate statements of the property department. The property department may have a vested interest in presenting an optimistic picture of the system.

Consequences associated with the reliability of information are cause for verification when the information is used for costly business decisions, such as buy-outs, new contracts, stock evaluation, market pricing, etc.

To understand the auditing process, you should become familiar with the definitions that are important to auditing.

1.4 Definition of Auditing:

A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

1.4.1 Systematic Process:

As a systematic process, auditing is a logical, purposeful, structured approach to decision-making; it is not an unplanned, haphazard process.

1.4.2 Objectively Obtaining and Evaluating Evidence:

Auditing involves the collection of evidence. Evidence represents the information collected by the auditor that will affect the auditor's decision process. Although evidence itself may be more or less conclusive in nature, the process of collecting and evaluating evidence should be objective.

1.4.3 Assertions about Economic Actions and Events:

Assertions are related to the financial statements of the organization being audited. The auditor is given information and statements from the auditee. These statements represent the auditee's assertions about actions and events and include not only the statements themselves but also the accounting system and process. (This statement looks, at first glance, to relate only to economic issues and financial statements. However, if you understand that property is in fact a function of economic values and that financial statements include statements of assets and inventories, you can see where property issues fit.)

1.4.4 Degree of Correspondence between Assertions and Established Criteria:

Correspondence here means the comparison of the assertions of the auditee to the established criteria. The established criteria may include, but are not limited to, the sorces such as:

- Generally Accepted Accounting Practices(GAAP)
- Federal Acquisition Regulations (FAR)
- State or Municipal Regulations
- Corporate Policies and Procedures

1.4.5 Communicating Results to Interested Users:

The communication of the auditor's assurance or information is referred to as attestation, or the attest function. Attestation is a communicated statement of opinion (judgment) based upon convincing evidence by an independent, competent, authoritative person concerning the degree of correspondence in all material respects of accounting information communicated by an entity with established criteria.

1.5 Features

- Assessment is a systematic and scientific examination of the books of accounts of a business;
- Audit is undertaken by an independent person or body of persons who are duly qualified for the job.
- Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.
- Audit is a critical review of the system of accounting and internal control.
- Audit is done with the help of vouchers, documents, information and explanations received from the authorities.
- The auditor has to satisfy himself with the authenticity of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.
- The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minute books of share holders,

directors, Memorandum of Association and Articles of association etc., in order to establish correctness of the books of accounts.

1.6 Standards

1.6.1 Professional Standards

Auditing standards represent a measure of the quality of audit work performed. They are broad conceptual guidelines that serve as a model for all auditors and should remain relatively stable over time.

Generally Accepted Auditing Standards (GAAS) are standards published by the American Institute of Certified Public Accountants (AICPA). The Auditing Standards Board issues pronouncements entitled Statements of Auditing Standards (SASs).

Auditing procedures, on the other hand, represent specific audit tasks to be performed. For example, to comply with an auditing standard that requires audits to be properly planned, the auditor may perform the specific audit procedure of holding a preliminary planning meeting with client personnel.

1.6.2 Common Standards

The examination is to be performed by a person or person having adequate technical training and proficiency as an auditor. In all matters relating to the assignment, the auditor must maintain an independent mental attitude.

Due professional care is to be exercised in the performance of the examination and the preparation of the report.

1.6.3 Standards of Fieldwork

Audits must be adequately planned and properly supervised. Proper planning must be undertaken to insure effective results. Planning must include the requirements for personnel and the logistics to support the personnel undertaking audits. Existing internal controls must be studied and evaluated to define the tests to be applied to the subject audit.

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation to afford a reasonable basis for an opinion regarding the statement under consideration.

1.6.3.1 Internal Control:

Internal controls consist of the plan of an organization and all of the coordinate 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 managerial policies. Internal controls represent the means by which a company processes its accounting transactions so that reliable financial information can be generated and safeguards its assets.

1.6.3.2 Sufficient Competent Evidential Matter:

Competent matter demands that the evidence is valid and relevant. An auditor must exercise professional judgement in determining the relevance of specific pieces of evidence and the objectivity, timeliness, and relationship to conclusions as to the overall fairness of the statements drawn from the audit.

1.6.4 Standards of Reporting

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an opinion cannot be expressed, the reasons should be stated.

In all cases the report should contain a clear-cut indication of the character of the auditor's examination and the degree of responsibility he/she is taking.

1.7 Suggested Code of Professional Ethics

1.7.1 Independence – Integrity – Objectivity:

An auditor should maintain integrity and objectivity and, when engaged in the practice of property management, be independent of those served.

1.7.2 Common and technical standards:

An auditor should observe the profession's common and technical standards and strive continually to improve competence and quality of services.

1.7.3 Responsibilities to clients:

An auditor should be fair and candid with clients and serve them to the best of the auditor's ability, with professional concern for their best interests, consistent with the auditor's responsibilities to the public.

1.7.4 Responsibilities to colleagues:

An auditor should conduct himself/herself in a manner that will promote cooperation and good relations among the members of the profession.

1.7.5 Other responsibilities and practices:

An auditor should conduct himself/herself in a manner that will enhance the stature of the profession and its ability to serve the public.

1.7.6 Auditor's Legal Liability:

We live in a litigious society. The auditor today can reasonably expect his or her every action regardless of how right or wrong it may be to be questioned in a court of law and possibly to result in substantial damages being awarded. Privity of Contract is a relationship between two or more parties that creates a contractual duty. In an auditing context, the auditor and client have a privity or contractual relationship that is usually established by a contract called an engagement letter. Usually, however, third parties such as investors or creditors are not parties to the contract and are said to have a nonprofit relationship. Due professional care is the performance of, and reporting on, a professional engagement with the degree of care, competence, learning, and experience commonly possessed by other embers of the auditing profession and required by professional standards.

1.7.7 Negligence

It is the failure of the auditor to perform or report on an engagement with the due professional care and competence of a prudent auditor. The auditor is negligent if he or she fails to do what the ordinary, reasonable, prudent auditor would do, or does what the prudent auditor would not do. Sometimes negligence may be referred to as simple or ordinary. Simple negligence, ordinary negligence, and negligence are synonymous.

1.7.7.1 Gross negligence

It is a serious occurrence of negligence tantamount to a flagrant or a reckless departure from the standard of due care. These terms are frequently used interchangeably and are equivalent to sloppy auditing or lack of a reasonable basis for a belief. A plaintiff in establishing gross negligence must prove each of the following assertions:

- The auditor made a representation about a material fact with lack of reasonable support.
- The purpose of the representation was to induce reliance by another (for example, a client or a third-party user of the financial statements).
- The representation was relied upon by the client or a third party.
- The reliance caused damages to the client or third party.

Fraud occurs when an auditor issues an opinion on the financial statements knowing that the financial statements or the audit report thereon are false. Fraud differs from gross negligence in that the auditor does not merely lack reasonable support for belief, but has both knowledge of the falsity and intent to deceive a client or third party.

1.8 Expression of Opinion

When we speak of the objective, we rationalize the thinking process to formulate a set of attainable goals, with reference to the circumstances, feasibility and constraints. In money matters, frauds and errors are common place of occurrence. Apart from this, the statements of account have their own purpose and use of portraying the financial state of affairs. The objective of audit, naturally, should be to see that what the statements of account convey is true and not misleading and that such errors and frauds do not exists as to distort what the accounts should really convey.

Till recently, the principal emphasis was on arithmetical accuracy; adequate attention was not paid to appropriate application of accounting principles and disclosure, for ensuring preparation of accounting statement in such a way as to enable the reader of the accounting statement to form a correct view of the slate of affairs.

Quite a few managements took advantage of the situation and manipulated profit or loss and assets and liabilities to highlight or conceal affairs according to their own design. This state of affairs came up for consideration in the Royal Mail Steam Packet Company's Case as a result of which the Companies Acts of England and India were amended in 1948 and 1956 respectively to require the auditor to state inter alia whether the statements of account are true and fair. This is what we can take as the present day audit objective. The implication of the substitution of "true and fair" need to be understood. There has been a shift of emphasis from arithmetical accuracy to the question of reliability to the financial statements. A statement may be reliable even though there are some errors or even frauds, provided they are not so big as to vitiate the picture.

The word "correct" was somewhat misplaced as the accounting largely consists of estimates. However, you should not infer that the detection of errors and frauds is no longer an audit objective; it is indeed an audit objective because statements of account drawn up from books containing serious mistakes and fraudulent entries cannot be considered as a true and fair statement. To establish whether the financial statement show a true and fair state of affairs, the auditors must carry out a process of examination and verification and, if errors and frauds exist they would come to his notice in the ordinary course of checking. But detection of errors of frauds is not the primary aim of audit; the primary aim is the establishment of a degree of reliability of the annual statements of account.

If there remains a deep laid fraud in the accounts, which in the normal course of examination of accounts may not come to light, it will not be construed as failure of audit, provided the auditor was not negligent in the carrying out his normal work.

1.9 Types of Audits

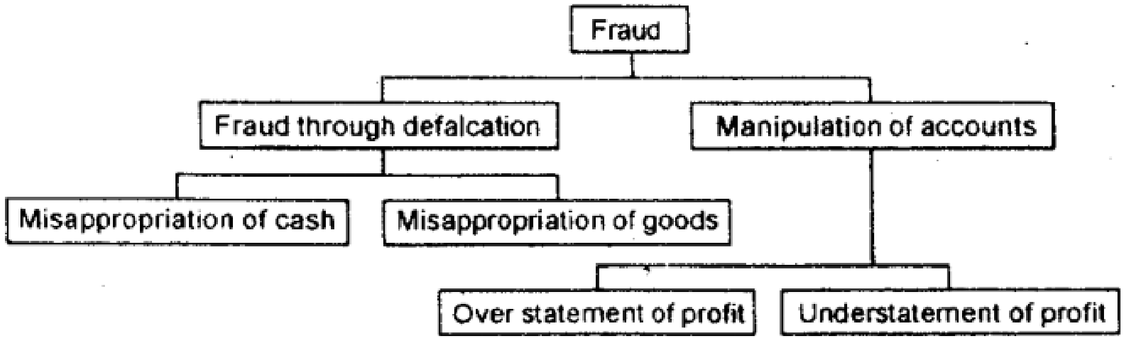
1. Audits of Financial Statements
2. Compliance Audits
3. Contract
4. Federal and State law
5. Policies and Procedures
6. Operational Audits
7. Effectiveness
8. Efficiency

1.10 Detection of Fraud & Errors

The term fraud means the willful misrepresentation made with an intention of deceiving others. It is a deliberate mistake committed in the accounts with a view to get personal gain. In accounting, fraud means two things.

- Defalcation involving misappropriation of either cash or goods
- Fraudulent manipulation of accounts not involving defalcation.

1.10.1. Fraud covers the following



1.10.2 Fraud through Defalcation

Following are the methods of defalcation involving misappropriation of cash or goods

- By misappropriating the receipt by not recording the same in the cashbook
- By destroying the carbon copy or counter foil of the receipt and misappropriating the cash received
- By entering lesser amount on the counterfoil and misappropriating the difference between money actually-received and the amount entered on the counterfoil of the receipt book.
- By not recording the receipt of sale of a casual nature for example sale of scrap, sale of old newspapers etc.
- By omitting to record cash donations received by non-profit making charitable institutions
- By misappropriating the cash received on discounting the bills receivable and showing them as bills outstanding on hand.
- By misappropriating cash received from debtors and concealing the same by giving artificial credit to the debtors in the form of bad debts, discount or sales return etc.
- By adopting the method of "teeming and lading" or "lapping process". Under this method cash received from one debtor is misappropriated and deficiency in that debtors account is made good when another payment is received from second debtor by crediting the second debtors account less by that amount. This process is carried out round the year.
- By suppressing the cash sales by not recording them or by treating the cash sales as credit sales.
- By misappropriating the sale proceeds of VPP sales or sales of goods on approval basis by treating the transaction as goods received or not approved.

- By under casting receipt side total of the cashbook
- By recording fictitious or bogus payments
- By recording more payments than actual amounts paid by altering the figures on the vouchers.
- By showing the same payment twice.
- By showing credit purchases as cash purchases and misappropriating the amount
- Recording personal expenses as business expenses
- By not recording discounts and allowances given by the creditors and misappropriating the amounts
- By overcasting the payment side total of the cashbook
- Recording fictitious and inflated purchases and misappropriating that amount.
- By suppressing the credit notes for returns and showing the full payment to creditors.
- By including the names of dummy workers or the workers who have? The job in the wage sheets and misappropriating the amount.
- By over casting the total of wages sheets and drawing that amount for misappropriation.
- By misappropriating the undisbursed wages.

1.10.3 Fraud through manipulation of Accounts

It implies presentation of accounts more favorably than what they actually are. Window dressing means showing a wrong picture. The fraud through manipulation of accounts is also known as window dressing because accounts are manipulated to show a wrong picture of the profit or loss of the business and its financial state of affairs. Commonly this type of fraud is committed by the people at the top management level. This does not involve any misappropriation of cash or goods but it is either over statement of profit or understatement of the same. Such fraud is committed with certain objective and is relatively difficult to detect.

1.11 Limitations of Auditing

At this stage, it must be clear that the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. In fact, it is the auditor's opinion which helps determination of the true and fair view of the financial position and operating results of an enterprise. It is very significant to note that the AAS-2 makes it a subtle point that such an opinion expresses by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted affairs of the enterprise.

Further, the process of auditing is such that it suffers from certain inherent limitations, i.e., the limitation which cannot be overcome irrespective of the nature and extent of an audit procedure. It is very important to understand these inherent limitations of an audit since understanding of the same would only provide clarity as to the overall objectives of an audit. The inherent limitations are:

- First of all, auditor's work involve exercise of judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgment and estimates made by the management in preparing the financial statements. Further much of the evidence available to the auditor can enable him to draw only reasonable conclusions there from.
- The audit evidence obtained by an auditor is commonly persuasive in nature rather than conclusive in nature. Because of these factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable. There is also likelihood that some material misstatements of the financial information resulting from fraud or error, if either exists, may not be detected.
- The entire audit process is commonly dependent upon the existence of an effective system of internal control. Further, it is clearly evident that there always be some risk of an internal control system failing to operate as designed. No doubt, internal control system also suffers from certain inherent limitations. Any system of internal control may be ineffective against fraud involving collusion among employees or fraud committed by management.
- Certain levels of management may be in a position to override controls; for example, by directing subordinates to records transactions incorrectly or to conceal them, or by suppressing information relating to transactions. Such inherent limitations of internal controls system also contribute to inherent limitations of an audit.

1.12 Importance

1. Errors are Located

Auditing is helpful for business. The error can be located through it. The location and correction of error is possible through auditing. The true and fair information about business is available.

2. Frauds are Discovered

Auditing is helpful for business. The discovery of fraud is possible through it. The guilty persons can be held responsible. The auditing accounts show fair about business.

3. Loans Become Easy

Auditing is useful for business. Lenders for granting loans accept the auditor's accounts. The reputation of borrowers increases due to auditing. Thus auditing accounts help the businessman to expand his activities.

4. Advise about Weakness

Auditing is useful for business. The people can seek advise from auditors. The auditors are professional and they know their work very well. They can spotlight the grey area. It is the duty of the business man to act upon the advise of the auditors.

5. High Moral Values

Auditing is essential for business. There is moral check on the management and other staff. Auditing puts the pressure on the staff of work honestly. There is no pending work so there is less chance of errors and frauds.

6. Tax Payments

Auditing is useful for business, tax authority accept audited accounts for assessment of taxes. There is no further inquiry or investigation from department. The audited accounts lessen the worries of business people.

7. Tax Owners

Auditing is useful for business. The tax authorities accept audited accounts for assessment of taxes. There is no further inquiry or investigation from tax department. The audited accounts lessen the worries of business people.

7. Efficiency Improves

Auditing is beneficial for business. The auditing determines the efficiency of employees. The training and qualifies management is an asset for any business. Such management can play dynamic role in framing and implementing the policies.

8. Dispute is settled

Auditing is essential for business. The audited accounts are helpful to settle the disputes. The audited accounts become the basis of making decisions. The dispute may relate to infringement of patents or trademarks.

9. Planning Becomes Possible

Auditing is helpful for business. The audits accounts present true and fair view of business activities. The facts and figures can be used to prepare budge and estimates for the next years. The projected cash receipts and payments, income statement and balance sheet can be prepared.

10. Improvement of Internal Control

Auditing is helpful for business. The auditor can point out the weakness of internal control system. The business management can take steps to remove these weaknesses. The effective control systems are essential for large-scale business enterprises.

11. Fluctuation in Profits

Auditing is helpful for business. The auditor can make the detailed study to find of fluctuation in profits. There are various reasons for changes in profits. The auditor can determine the true cause of such changes.

12. High Credit Rating

The auditing is beneficial for business. The auditing accounts increase the credit standing of any business house. The lenders can rely on audited accounts for granting credit facility. In fact auditing is a screening test of business entity.

13. Listing at Stock Exchange

The auditing is beneficial for business. The listing of securities at stock exchange is optional. The public limited companies can get registration at stock exchange. Stock exchange management for registration purpose accepts the audited accounts.

14. Shareholders Protection

Auditing is beneficial for owners. The shareholders feel that their rights are protected through auditing. They can know the performance of management. Audited accounts help to determine the value of shares.

15. Partner Satisfaction

Auditing is helpful for partners. The sleeping partner feels satisfaction when there are audited. The managing partners can use business property for their personal benefit. There is moral check on managing partners.

16. Proprietors

Auditing is useful for proprietors. The audited accounts help the sole traders that their business is going on properly. The error and fraud are pointed out auditors. The owners can determine the efficiency of their employees or assistants.

17. Beneficiary

Auditing is valuable for beneficiaries. The auditor of a trust can nominate any person as trustee to look after the property of a trust. Auditing can safeguard the right of beneficiaries. There is a moral check on the trustee to follow the by – laws of trust.

18. Deceased Estate

The auditing is helpful for dependents of decreased person. The audited accounts presents true and fair view of financial statements. The family can rely on audited accounts for distributing the estate of deceased person.

19. Insolvency

The auditing is beneficial for creditors. The audited accounts show true and fair view of state of affairs of sole proprietorship or partnership. The creditor can get their money first and then owners can get refund of capital. The audited accounts help to settle the cases at an early date.

20. Better Performance of Tax Department

Auditing is beneficial for government. Tax officers accept the audited accounts. The assessment order can be issued without further clarification. There is saving of money and time due to audited accounts. The performance of tax officers is improved.

21. Exact Revenue Amount

Auditing is beneficial for government. The collection of revenue is possible at an early date. The people are allowed to deposit various kinds of taxes. The recovery of income is made at the start of the year. The government can start welfare project on the basis of total revenue collected.

22. Progress of Economy

Auditing is essential for government policies. The true fair view is stated in audited accounts. The stage of economic progress can be determined. The government can take measures to raise the rate of economic growth.

23. Purchase of Private Business

Auditing is helpful for government. The private business houses may not work in favour of common public. The government can take over such business units. The purchase price is decided on the basis of auditing of accounts.

24. Sale of Government Business

Auditing is useful for government. The policy can be framed on the basis of audition accounts. The management comes to know the value of business. The government can sell state – owned unit to private sector. The bid price is settled on audited accounts.

25. Inspectors

The auditing is helpful for government. The auditing accounts show the fair value of all assets. The value of assets is the basis of tax. This issue can be settling through audited accounts. The auditors are experts in their field. They know all methods of property valuation. They can issue certified the government agencies for valuation of property.

26. Insurers can Settle Claims

Auditing is essential for insurers. The settlement of fire or marine insurance claims is easy through audited accounts. The policy holders and insurance company can settle actual loss of property.

27. No Loss to Lenders

Auditing is essential for lenders. The banks and other lenders ask the borrowers to submit audited accounts before granting loans. The audited accounts are helpful to check the trust worthiness of customers.

28. Creditor are Protected

Auditing is essential for creditors. They can know the true performance of their debtors. The creditor can accept this promise only when he feels that debtor is reliable businessman. Auditor accounts provide basic information about reliability.

29. Bidders Can Offer High Rate

Auditing is helpful for bidders. Audited accounts provide information about net worth of any business. The people interested in purchasing the business can rely on such information. They know the fair value of business. They can offer reasonable price through open bidding.

30. Better Pay to Employees

Auditing is helpful for employees. They are interests in profits. Auditing accounting proves true and fair view of profit. The employees can demand higher pay, fringe benefits and participating in profits. Audit of accounts with the independent person help the employees to make settlement with the employers.

31. Investors Can Take Decisions

Auditing is helpful for inventors. The audited accounts can be used to calculate value of shares and other securities. The bargains power is given to the people who have money and they want earn income. They can protect their rights through reliable information.

Review Questions

1. What is the Auditing?
2. What is the purpose of Auditing?
3. State the Importance of Auditing?
4. Describe about the frauds occurring in Auditing?

Discussion Questions

Discuss the status of the type of frauds that can occur while maintaining your books of accounts. Discuss with an Auditor to get it rectified?

Application Exercises

1. Is Auditing really required in a Business accounts?
2. Explain the importance of Auditing?

Fundamentals of Auditing

Learning Objectives

Upon completion of this chapter you will

- Understand the concept of internal audit.
- Enumerate the features of nature of internal audit.
- Know the idea about statutory audit.
- Knowledge about internal checking of audit.
- Understand the features and importance of internal audit

Chapter-2 Internal Control

2.1 Introduction

Internal control is another important area of auditing. Internal control refers to a number of checks and controls exercised in a business to ensure its efficient and economic working. In this chapter you will learn the meaning and objectives of internal control and internal check. You will also learn various system of internal check and generally understand audit in respect of computer environment.

2.2 Meaning and Definition

Internal control is an important tool of management. It assists the management in the performance of its various functions. It means the built in cross-checks in the system supplemented with proper supervision and internal audit carried out by the staff appointed by the organisation These days business has been become more complex both in nature and size and the management finds it difficult to get correct information about the various aspects of the business. Internal control assures the management that the information supplied to it is reliable and accurate.

The Internal controls are exercised to ensure the accuracy and the reliability of accounting data and other records, to identify weaker areas of operation and to improve them to increase operational efficiency of the business, to safeguard its assets and to ensure orderly conduct of business.

The American Institute of Public Accountants has defined internal control as the plan of organisation and all the co-ordinate methods, and measures adopted within a business to safeguards its assets, check the accuracy and the reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. A system of internal control extends beyond those matters which relate directly to the function of the accounting and financial departments.

The Institute of Chartered Accountants of England and Wales defines internal control as "internal control means not only internal check or internal audit, but the whole system of control financial and otherwise, established by management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible accuracy and reliability of its records".

If we analyze the above definitions it would be evident that internal control is a broad term with a wide coverage. It consists of a number of checks and controls which are exercised in a business to ensure its efficient and economic working. Thus internal control involves a sort vigilance and directions over important matters like budget and finance, purchase and sales and internal administration by the management.

Every business enterprise is expected to devise a suitable system of internal control in order to carry on the business in an efficient and orderly manner. These controls are accounting control, budgetary control, statistical analysis and internal checks and internal audit. In simple words, it means number of checks and controls over the various activities of a business. Generally, a system of internal control will include all those measures which assist a business enterprises to fulfill the following objectives.

- To minimize, if not completely eliminate, wastage and inefficiencies in business operations and to safeguard the assets of the business.
- To ensure high degree of accuracy and reliability of accounting data and promote operational efficiency.
- To measure how far the policies of the management are being implemented,
- To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.

2.3 Forms of Internal Control

Various forms of internal control help in ensuring correct and reliable records of transactions and operational efficiencies.

2.3.1 Accounting control

It ensures correct and reliable records of transactions in conformity with normally accepted accounting principles. Such controls comprise primarily the plan of organisation and the procedures and records that are concerned with and directly related to the safeguarding of assets and liabilities of financial records. Accounting financial controls include budgetary control, standard cost control, self balancing ledger, bank reconciliation and internal checks and internal auditing.

Accounting controls deal with the process of recording of transactions, safeguarding the assets and adherence to prescribed managerial policies

2.3.2 Administrative control

The scope of this control is very wide. They also include accounting controls. Such controls comprise of the plan of organisation that are concerned mainly with operational efficiencies. In short they may include anything from plan of organisation to procedures, record keeping, distribution of authority and the process of decision making. They include controls viz. Time and motion studies, quality control through inspection, statistical analysis and performance evaluation etc. An auditor should make a careful review of accounting controls as they have a direct bearing on the reliability of the financial statements. He is primarily concerned with the accounting controls.

2.3.3 Internal control and auditor

The position of the auditor regarding internal control has been stated in the statement of auditing practices issued by the Institute of Chartered Accountants of India which says "the duty of safeguarding the assets of a company is primarily that of management and the auditor is entitled to rely upon the safeguard and internal controls instituted by the management, although he will take into account the deficiencies, he may note therein while drafting his audit program".

It clearly means that an auditor is concerned only with the evaluation of internal control to know its strength and weaknesses. In case he finds that the internal control system is inadequate, he should then plan to carry out detailed examination of those areas where the system is weak. It is therefore necessary for the auditor to acquaint himself fully with the internal control in force and their actual operation. It will help him in the formulation of his audit program. He may also bring the shortcomings of the internal control system to the notice of the management.

2.4 Requisites of a good internal control system

The following are the essential requisites of a good internal control system:-

i. A well developed plan of organisation with proper delegation of functional responsibilities should be aevised. No internal control system can be effective without such plan of organisation.

ii. A scientific system of authorisation and record procedure should be developed with a view to provide proper control over assets, liabilities, revenue and expenses of the organisation. It should be developed in such a fashion as to ensure that:

a) assets are under proper custody and they are not improperly applied,

b) expenditures are incurred on getting proper authorisation

c) revenues received are duly accounted for.

iii. A system of healthy practices and traditions should be developed with a view to discharge the duties and functions of the various departments of the organisation smoothly.

iv. Since internal control system is to be exercised by the personnel employed in the organisation, there should be a team of people with sound character and integrity who are properly trained and capable of discharging their responsibilities.

v Constant managerial supervision and periodical review of the system should be introduced with a view to make the system more efficient and effective.

2.5 Internal Audit

Internal audit is described as the verification of the operations within the business by a specially assigned staff. It is an important tool of management to evaluate the correctness of records on a continuous basis in an organisation.

The term internal audit has been defined as "an independent appraisal of activity” within an organisation for review of operations as a basis of service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls.

According to Howard F. Stettler, "internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to management.”

The overall objective of internal auditing, therefore, is to assist the management in the effective discharge of their responsibilities by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed.

In short internal audit assures the management that the system of internal check and other types of controls are effective in design and operation.

Thus, internal audit is a thorough examination of the accounting transactions to ensure that-

- The transactions are properly recorded.
- The accounts are maintained systematically and
- There is no possibility for manipulation of accounts or misappropriation of property of the business.

In modern times, an internal auditor carries a new task. The traditional function of checking the arithmetical correctness of the accounts with the help of vouchers and documents and verification of few items such as stock, cash and fixed assets is not sufficient. The duty of internal auditor now is to chart the procedure, examine the efficiency and work on programs of improvement of assessing the effectiveness of controls. He is expected to plan and arrange his task for effective functioning, set clear objectives of his own section, phase his objectives, gain the confidence of the management and demonstrate the value of his functions in areas of performance.

The internal audit is carried out generally in the same manner as is followed for a professional audit. However, it varies in form from enterprise to enterprise according to its size and specific needs. It is installed in large organisation and is carried out by the salaried staff who are qualified to conduct professional audit. Being the employee of the organisation he has to ensure that there is no waste in the organisation.

Internal auditor has to follow the provisions of law, standard auditing practices and procedure prescribed for professional auditors and by the professional bodies controlling the audit system in the country. At the same time internal auditor must be aware of the policies and programs of the enterprise he should be professionally competent to carry out a detailed examination of the working of the business. Equipped with professional expertise and knowledge of the business, he will be in a better position to make the internal audit system more effective.

2.5.1 Objectives of internal audit

The main objectives of internal audit are as under:-

1. To verify the correctness and authenticity of the financial records and statistical records presented to the management.

2. To ensure that the standard accounting practices are strictly followed in the organisation.

3. To facilitate early detection of errors and frauds.

4. To ensure that all the transactions have been carried out under a proper authority and by persons authorised for the same in the business.

5. To review the system of internal check from time to time to advice the management on improvement of the system and to undertake special investigation for the management.

6. To confirm that the liabilities have been incurred by the organisation for legitimate activities.

Thus, efficiency of internal audit depends on the efficiency of the staff employed for the purpose, internal audit can be effective only if the internal auditor is given wider authority to investigate the transactions not only from financial angles but also from other organizational activities.

Internal auditor should report directly to the top management. He must operate independently of the accounting and other staff. He must be given an independent status as an important functionary and a part of the management.

2.5.2 Internal audit v/s statutory audit

Internal audit helps the statutory audit to a large extent. Both the internal auditor and the statutory auditor have a common interest as far as authenticity of the accounts are concerned. However soundness of internal audit relieves the statutory auditor from detailed checking.

The internal auditor reviews the operations and performs such functions as evaluation, compliance, verification and ensures that policies, procedures, rules and other type of controls of the business are carried out efficiently.

He is helpful to statutory auditor in the matter of examination of books of accounts. Generally, the statutory auditor accepts some of the detailed checking made by the internal auditor. However, the area of cooperation between internal auditor and statutory auditor is somewhat

limited as the statutory auditor has a responsibility under law to various authorities, while the internal auditor is responsible only to the management. The statutory auditor has to carry out his duties in accordance with standard accounting and auditing practices and provisions of law which govern the organisation. Before accepting the checking of accounts and other documents carried out by internal auditor, the statutory auditor must undertake such test checks necessary to find out the effectiveness of internal audit.

Both internal auditor and statutory auditor carry out examination of records and documents and make physical and other verifications. Despite these similarities there are differences in the status, responsibilities, approach and scope of work of internal auditor and statutory auditor.

2.5.2.1 Features of internal audit and statutory audit-

The following are the points of differences between internal audit and statutory audit:

Internal audit

1. Internal audit is the arrangement within the organisation to verify on continuous basis the correctness and truthfulness of the transactions by the salaried staff.
2. Internal audit is not compulsory.
3. Internal audit is carried out by the staff appointed by the business enterprises. It is not necessary that the internal audit staff should possess the qualification prescribed for professional auditor
4. Being an employee of the organisation internal auditor is answerable to the management. His duties, responsibilities etc. regarding audit work are determined by the management. The management can increase the powers and authority of the internal auditor. Similarly it can also curtail his powers.
5. The internal auditor points out irregularities in the procedural aspects and suggests ways and means to rectify the same. He assures that the financial operations and other types of control in force are carried out in conformity with the accounting systems.

Statutory audit

1. Statutory audit is the examination of the books of accounts of the business by an external auditor and to report that the profit and loss account and balance sheet are drawn according to provisions of law and the financial statements reveal the true and fair view of the results of operations and financial state of affairs of the business.
2. Statutory audit is compulsory in case of business houses incorporated under the Companies Act and other acts.
3. Statutory audit can be carried out only by those who are qualified for appointment as per the provision of the Companies Act and other acts.

4. The rights, duties, responsibilities and liabilities of auditors are governed by the provisions of law. The auditor is independent of management.

5. The statutory auditor is concerned with the legality and validity of the transactions of business. His audit work is based on the financial statement prepared by the business.

2.6 Internal Check

Internal check is a system enforced in business under which the recording of business transactions is arranged in such a manner that the work of one staff member will automatically be checked by others in the course of recording of transaction itself.

Spicer and Pegler have defined a system of internal check as "an arrangement of staff duties whereby no one person is allowed to carry through and record every aspect of a transaction such that without collusion between two or more persons., fraud is prevented and at the same time possibilities of errors are reduced to a minimum".

De Paula has defined internal check as "a continuous internal audit carried on by the staff itself by means of which the work of each individual is independently checked by other member of the staff." Thus, under internal check system the staff duties are so arranged that no one person is allowed to record every aspect of the transactions and the entire work is distributed among the various members of the staff in such a manner that the work of one person is automatically checked by others.

The essential elements of internal check are as under-

- Existence of checks on day to day transactions.
- The check is to be carried out continuously as a part of the routine system.
- The work is divided among the staff and each staff is assigned a specific task.
- The work of each staff though independent is complementary to the work of another.

The system of internal check is increasingly recognised by the auditor specially when the size of the concern is large. The existence of effective internal check system relieves the external auditor of detailed checking to a larger extent. The extent to which an external auditor can depend upon the system of internal check is based on the procedural tests applied by him to find out the effectiveness of the system. However the auditor can not be relieved of his responsibility if he was found guilty of negligence regardless of the fact that he had tested the internal check in existence in the organisation before he had accepted it as correct.

2.6.1 Objectives of internal check

- To reduce chance of fraud and errors that may be committed by any member of the staff and make it more difficult. If any fraud is to be committed two or more persons must collude together.

- To detect fraud and errors easily and correct them promptly.
- To exercise moral pressure among the members of the staff.
- To allocate duties and responsibilities of every person in such a way that he can be taken to task for any lapse on his part.
- To increase overall efficiency of the members of the staff by assigning duties based on the principle of division of labour.
- To have an accurate and reliable record of all business transactions.

2.6.1.1 Essentials of good internal check system

- No single staff shall have absolute control over recording of all the aspects of business transactions by himself.
- The same staff shall not be allowed to have access to all books of accounts as well as physical custody of the assets.
- Each member of the staff should be made responsible for a specific work.
- All officials and employees holding responsibility towards cash, securities or stock should be encouraged to proceed on annual leave to prevent the concealed fraud.
- The duties of the members of the staff should be changed from time to time.
- Attempt should be made to introduce mechanical devices to prevent mis-appropriation of cash.
- Each transaction should pass through a definite route and through several hands.
- All books, vouchers, documents should be classified and made available for easy reference.
- Proper record must be maintained of the incoming and outgoing of goods from the business premises.
- Self balancing ledger system should be introduced to make the system more efficient and effective.
- No undue importance should be given to any staff member and too much reliance on any staff member should be avoided.
- Division and allocation of duties among the staff members must provide for an automatic check by others.

2.6.2 Internal check as regard cash sales

Since chances of committing fraud in connection with cash sales are greater, it calls for devising an efficient and effective system of internal check. Cash sales may be affected in various ways like:

- sale at counter
- postal sales, i.e. sales under mail order
- sales by representative and agents.

The system of internal check to be followed in each case is discussed below.

- One salesman should be appointed to look after one counter independently and should be made responsible for sales effected in his counter.
- Each salesman must be issued with a separate cash memo book. The cash memo book must be printed in different colours to identify different counters of the business.
- Each salesman must maintain a sales sheet. He should record therein the sales effected by him. The summary of cash sales effected by him must tally with the cash memos issued by him.
- Cash memos are to be issued with carbon copies.
- The salesman must not receive cash on the cash memos issued by him.
- All payments on the cash memo of the salesman must be made by the customer at the cash counter.

2.6.2.1 Sales are to be effected in the following manner

- Three copies of the cash memo must be issued to customer
- The customer must present the three copies of cash memo to the cashier at the time of making payment
- The cashier must verify the particulars and satisfy himself regarding the total payment with reference to rates and quantity.
- The cashier on receiving the payment in cash will place a rubber stamp on all the copies of memos as "cash paid".
- He will retain one copy with himself and hand over the other two copies to the customer.
- The customer must present the cash memos to the delivery department to collect the goods purchased.

- The delivery department will put rubber stamp on the memos as "goods delivered". It will retain one copy as an evidence for delivery and hand over another copy of the memo to the customer.
- At the end of the day's working, the sales man, the cashier and the gate keeper should prepare the summary and submit to the manager or officer incharge. If these summaries tally, the accounts are certified as correct.

2.6.2.2 Postal sales i.e. sales under mail order

This includes following aspects:

- All sales made by post i.e. V.P.P should be recorded in a separate register to be maintained for the purpose.
- The goods returned, if any, should also be recorded in the register.
- The total amount of cash receipts including advance, if any, against the mail orders should be entered in the register and the same should be deposited into the bank.
- All the entries in the V.P.P. register should be checked by some responsible officer and special inquiries should be made in respect of those goods against which cash has not been received.
- There should be proper filing of mail orders received and the cash book should be checked with these mail orders.

2.6.2.3 Sales by representative and agents

It is the practice in big business houses to employ representative and agent to promote sales and to collect the amount due from debtors. The system of internal check to be introduced in this connection should be as follows:

- The representatives and agents should be authorised to issue rough receipts to the customers against cash received from them. However, the final receipt should be issued only by the head office.
- The customers should be advised to communicate directly with the head office if they do not get the final receipt within a reasonable time period.
- The representatives and agents should be instructed to remit the amount of cash collected by them to the head office without any delay.
- The representatives and agents must not be allowed under any circumstances to deduct their commission or any other expenditure from the amount of

cash collected by them. The bill for commission and other expenses should be submitted to the head office.

- As a matter of routine the head office should send periodical statements of accounts to the customer with a view to apprise them of the latest position.
- The representatives and agents should be advised to submit periodical statements to the head office showing therein the amount of sales made by them, the amount of cash collected by them and the names of the defaulters.
- The head office should issue reminders to those defaulting customers who have failed to clear their dues.
- The representatives and agents must not be allowed to operate from a fixed place. On the contrary, they should be transferred from time to time to other place in order to increase their efficiency and to avoid the possibility of committing fraud.

2.6.3 Internal check as regards purchases

Since chances of committing fraud in connection with the purchases of goods by a big business house are greater, it calls for devising an efficient and effective control system of internal check. In this connection one should be familiar with the purchases procedure which should be as under.

- The department requiring the material should fill in the purchase requisition indicating the quantity and quality to the purchase department.
- The purchase department on the basis of the requisition will send out enquiries to the various suppliers asking for quotation.
- On receipt of quotations the order will be placed on the best vendor taking into account the quality, period of delivery, competitive prices etc.
- On receiving the order the vendor shall execute the order. The supplies will be received by the stores department.
- On receipt of goods it will be verified with reference to the order with the goods received memo issued by the stores department. If the supplies are made according to the order the delivery note and invoice sent by the supplier will be forwarded to accounts department with endorsements for the goods received and taken to stores.
- The invoice will be passed for payment by a senior officer after verifying the terms and conditions of the supply with reference to rates and quality and other expenses detailed.

Keeping the above points in view, the following system of internal check is suggested with regards to purchase:

- There should be separate purchase department.
- Purchase order are to be issued only against indents received from the various department of the business.
- All orders should be a placed in writing. The order form must be preferably a printed form containing full details.
- The orders must be made in quadruplicate. One copy of the order is to be sent to the supplier. The second copy is to be sent to the concerned department which has placed the indent for supply; third copy is to be sent to account sdepartment and the fourth copy is to be retained by the purchase department for future reference.
- All orders for purchase, should be signed only by the purchase manager or the person authorised for this purpose.
- All orders should contain the seal of office.
- The goods received should be inspected with the copy of the order.
- The goods received are to be examined with delivery notes and supply invoices of the seller regarding quantity, quality and rates.
- The purchase department should make an endorsement putting rubber stamp on the suppliers bill with reference to goods received.
- After inspection and examination 'Goods Received Note' is to be prepared for each lot of purchase. The inspection note should also be attached to it.
- Endorsement must be made by the purchase manager or the authorised official (of stores department to take the goods into stock.
- The stores department should acknowledge receipt of goods and send the same to the order department.
- All packages of incoming goods are to be opened only in the presence of a responsible official.
- The stores officer on verification of the correctness of the goods received should enter them in the stock register.
- Generally a rubber stamp containing the following certificate will be placed on the suppliers bill and signed by the purchase manager

"Certified that goods are received as per Order

No,..........Dated..........and taken to stock vide Folio No,............ of stock register No,..........."

- The Payment on purchases must be made only after accounts department verifies the invoice, goods received note and purchase order.
- The accounts department should impress a rubber stamp on invoices which are passed for payment.
- A separate purchase register is to be maintained by the purchase department
- Ledger clerk should have no access to physical stock register or cash to avoid manipulation of accounts.
- For inter-branch purchase or inter-company purchases transfer notes should be issued.
- All Purchases that are made by employee for the personal use must be accounted for separately.
- A separate return outward book is to be maintained to record the return of goods to suppliers.
- Credit notes are to be issued for adjusting claims. The purchase department should send a copy of credit note to accounts department.
- A purchase ledger control account is to be maintained. Ledger account should be checked periodically against the suppliers statements.
- A perpetual inventory control method should be adopted to avoid excess quantity and to maintain minimum quantity.
- Where goods are delivered directly to locations or place of work not controlled by the purchase department, the invoices are to be passed by the purchase department only after examining the certificate of receipt of stock from the authority to whom the goods are delivered.

In general the purchase department must place purchase orders on the basis of indents, record the order in the purchase day book, enter the goods received in the goods inward book and send the invoice of the supplier alongwith the inspection report and goods received notes to the accounts department for payment.

Internal check as suggested above will avoid irregularities in purchase and minimize, if not completely eliminate, manipulation of accounts by entering fictitious purchase or entering invoice twice or misappropriating the discount or commission allowed by the suppliers.

2.6.4 Internal Check as regards Sales

The organisation of the sales department depends on the system of selling and distribution of goods. Unless the department is organised properly there are greater possibilities for suppression of sales and manipulation of accounts. Goods can also be misappropriated. Hence, a well-knit system of internal check is necessary which may be in the following manner:

- Sales must be executed against order received from customers.
- All incoming orders shall be numbered and filled and confirmation of the orders received be sent to the customers.
- Proper record is to be maintained for the orders received, order under execution/executed/refused.
- The sales shall be authorised by responsible officials after scrutiny of the order and assessing the portion of supply of goods as well as the terms and conditions of sales accepted by the customer.
- All sales orders shall contain invoices prepared in quadruplicate. One copy is to be retained by the sales department, one to be sent to the customer, one to the accounts department and the last copy to despatch section for despatch of goods.
- Separate departments should deal with cash sales and credit sales.
- In the case of credit sales a separate register should be maintained of the customers with financial standing. The credit sale is to be allowed only after scrutiny of the customer's order for supply of goods on credit.
- Periodical statement of the outstanding balance due towards the customer be sent and confirmation obtained from them.
- Regular reminders for payment shall be made to the customers reminding them of their dues.
- Amount due from the customer shall be written off as bad unless all methods of recovery are exhausted.
- The responsible official shall be entitled to treat a debt as bad. 88
- The sales invoice clerk shall have no access to physical stock or accounting records.

- The credit note shall be prepared only after ascertaining the fact from the despatch section and the sales department for the goods received back from the customers. Credit notes are to be prepared in quadruplicate. One is to be retained with the invoice department, second copy is to be sent to despatch department, third copy to the sales department and fourth copy to the customer.
- In case sales are cancelled, a notice is to be given to the despatch department to stop despatch of goods.
- The invoice can be cancelled only by the sales department. All sales invoices must be printed and numbered in serial order.
- The sales ledger shall be maintained by a separate clerk.
- Periodical statements should be sent to debtors.
- In the case of credit sales regular confirmation should be obtained from the customers regarding the outstanding balances. The confirmation of balances must be verified by a senior person other than the ledger clerk.
- A sales ledger control account shall be balanced with the control account periodically.
- A sales ledger control account in the general ledger shall be maintained.
- Credit to employees can be allowed only after proper authorization from the management. 89
- Separate department should be set up to deal with sales on consignment, hire purchase, goods on sales or return etc.
- The stock held by the agents should be verified periodically with the statements received from the agents.
- The goods sent on sale or return basis but unsold on the date of the balance sheet should not be treated as sales but unsold stock. Internal check system with regards cash received on sales is suggested under the caption "cash sales". The internal check of the sales department included the suggestions given for internal check on cash sales.

2.6.5 Internal Check as regards Wage Payment

In big organization, the work regarding the maintenance of various type of wage records, computing the amount of wages and the payment of wages to the right persons are of significant importance. It is, therefore, necessary to design a proper system of internal check regarding wages payment to minimize the dangers of fictitious names, errors in wages records and misappropriation of money. The following system of internal check is suggested:

- Workers should be employed only after the written order of the Personnel Officer or the appointing authority. A copy of the appointment order be endorsed to the wage preparing section.
- Separate staff should record attendance of workers, control of leave, payment of overtime and disbursement of pay packets. Each staff member shall be responsible to enter relevant information in the wage sheet. He should also put initials for the work completed by him.
- The wage sheet shall contain columns for recording relevant information with regard to payment of wages such as name of the employee, designation, period for which wages are paid, rate of pay, amount of basic pay, dearness allowance, house rent allowance, compensatory allowance and other allowance, gross salary drawn, deductions (there should be separate columns indicating the nature of deductions) and net amount payable and signature of employees, for acknowledging the payment.
- Separate records should be maintained for each worker indicating the date of appointment, scale of pay, rate of pay, etc. Copies of orders relating to increase in pay, promotions and punishments, deduction in wages on account of Provident Fund, Loan, Medical, Ground Insurance etc. shall be endorsed to wage preparing section.
- Separate job cards are to be maintained for recording the work performed by the worker.
- Each worker is to be given a pay slip indicating the gross wages and net wages.
- Separate register is to be maintained for recording the name of workers who may be allowed to work overtime. No worker shall be allowed to work overtime without the prior sanction of the proper authority.
- Time recording clocks shall be installed at the main gate of the factory for recording the arrival and departure of workers.
- The rosters of workers for each work should be prepared and copy of the same be sent to the wage preparing section.

- Late arrival of workers shall be entered in a separate register and the same be sent to the personnel section for future reference.
- Proper watch and ward arrangement is to be maintained to record the arrival of the workers and the time of leaving the factory.
- The rate of wages of each worker is to be periodically checked with reference to rate card.
- All calculations regarding gross wages and net wages payable after deduction are to be checked by an independent person.
- In the wage sheet the names of workers, rates of pay, the period for wage to be paid shall be entered by one person. The calculations regarding gross wages payable shall be made by another person.
- The deductions under various heads shall be made by a third person. The net wages payable and the checking of the wages sheet with reference to leave deductions etc. should be made by a senior staff member. The wages sheet shall be signed by the authorised official.
- If the wages are to be paid on the basis of piece wage system, the actual work done by each worker must be maintained on a job card to be given to each worker. These cards should be counter signed by the foreman of the department and the store department to which the goods produced are delivered.
- The wage sheet shall be prepared in triplicate. One copy shall be endorsed to pay master, the second copy to the account section and final copy shall be retained by the wage preparing section.

2.6.6 Internal check system and auditor

The soundness of the system of internal check and the way it is put into operation in the organisation are matter of great importance for the auditor. In case the system of internal check is effective the work of the external auditor becomes quite easy. He is relieved of the detailed and routine checking of the transaction as the internal check system takes care of the same. In case the internal check system is not effective, then the auditor should have to decide the extent of detailed checking to be undertaken in order to satisfy himself about the authenticity of the business records. It is, therefore, necessary for the auditor to study the system in force in the organisation; this he can do by applying few test checks and if the results are satisfactory he can depend on the internal check system.

In case the internal check system in force is weak or defective then he should carry out detailed checking of the accounting records. In case he does not do so he may be held liable for all the undetected errors and frauds. He should not show any negligence in his duty. He should design the audit program keeping in view the weak links of the system. He should also suggest the changes to the management strengthening the system of internal check.

It should be noted that the existence of a sound internal check system in an organisation helps the auditor to a great extent in audit work, but does not reduce his legal liability at all.

2.6.7 Audit in respect of computer environment

The principal object of the audit is to ensure that the accounts on which the auditor is reporting show a true and fair view of the state of affairs at a given date and of the results for the period ended on that date. The essential features of an audit appropriate for medium or large sized concerns are :-

a) An evaluation of the system of accounting and internal control to ascertain whether they are appropriate for the business and properly record all transactions

b) The making of such tests and enquiries as are considered necessary to determine whether the systems are being operated correctly.

c) An examination of account in order to verify :-

- The title, existence and value of the assets appearing in the balance sheet and to verify that all liabilities are correctly included therein.
- That the result shown by the profit and loss account is fairly stated. And to ensure that such accounts are in accordance with the underlying records and comply with the appropriate statutory requirements.

The overall scope and objective of an audit does not change in an E.D.P. environment. However, the use of a computer changes the processing and storage of financial information and may effect the organisation and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by an EDP environment.

The prime objective of EDP audit is to determine whether computer system safeguard assets, maintain data integrity, achieve organizational goals effectively and consume resources efficiently. A proper system of internal control is necessary to ensure that the objectives are met. It may be remembered that the overall objectives and scope of an audit does not change in an EDP environment. However, the use of a computer changes the processing and storage of financial information and may affect the organisation and procedure employed by the entity to achieve adequate internal control.

The auditor should take the following steps in addition to the normal audit procedure while auditing the computerised accounts.

- Computerised accounting involves the code list for various types of accounts. The auditor should obtain the list of such codes and ensure that they are correctly used.
- In manual accounting procedure each and every stage of recording the transactions is visible viz Preparing vouchers, passing entry, posting in ledger, casting, balancing, grouping, pre-paration of trial balance and final accounts. However, when the accounts are computerised it is not possible for the auditor to check each and every stage of recording the transactions as every thing is done by the computer behind the screen. Therefore, in such a situation it becomes necessary for the auditor to ensure that the functioning of the computer is correct and reliable. For this purpose he should select a sample of some transactions for processing and should compare the results obtained through computer processing with predetermined result.
- In case of computerised accounts, the records of transactions are stored on floppy disks as back up data. These disks are affected by heat, dust etc. The auditor should ensure that proper precautions have been taken by the client for the safe custody of such disks.
- He should ensure that client has made a proper arrangement for protecting the computer data from "Virus".
- He should ensure that there is proper control over the use of computers by the various users through "Passwords"
- He should ensure that there is proper maintenance of computers by doing servicing at regular intervals. This will reduce the chances of break down and losses of records.
- The accuracy of computer output depends upon the correctness of input. He should ensure that there is a proper system for checking of the output with the inputs on a regular basis.

- Lastly, he should ensure that changes in software programs are carried out by authorised person only and such changes are property noted for future reference.

2.7 Review

A review of internal control can be done by a process of study, examination and evaluation of the control system installed by the management. The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organization charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system. To acquaint himself about how all the accounting information is collected and processed and to learn the nature of controls that makes the information reliable and protect the company's assets, calls for considerable skill and knowledge.

In many cases, very little of this information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.

To facilitate the accumulative of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

(1) Narrative record;

(2) Check list;

(3) Questionnaire; and

(4) Flow chart;

The narrative record is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a system is in operation and would be more suitaed to small business. The basic disadvantages of narrative records are:

1. To comprehend the system is operation is quit difficult.
2. To identify weaknesses or gaps in the system
3. To incorporate charges arising on account of reshuffling of manpower, etc.

Review Questions

1. What is an Internal Audit?

2. Write the features of Internal Audit Control?
3. How auditing is possible in case of Computer Environment?
4. Describe about statutory audit?

Discussion Questions

If you are an Auditor, what necessary steps you will follow to cross check the acounts?

Application Exercises

1. Is Internal Checking is really fruitful in cross checking? Explain?
2. Explain the process of rewing an Internal Audit?

Fundamentals of Auditing

Learning Objectives

Upon completion of this chapter you will

- Understand the concept of Audit Planning.
- Enumerate the features of Audit Programme.
- Know the idea about Audit papers.
- Knowledge about process involved.

Chapter-3 Audit Planning

3.1 Meaning

As per Auditing and Assurance Standard, "Basic Principles Governing an Audit", Audit Planning is one of the basic principles. Accordingly, it states "The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business. Plans should be made to cover, among other things:

(a) Acquiring knowledge of the client's accounting systems, policies and internal control procedures;

(b) Establishing the expected degree of reliance to be placed on internal control;

(c) Determining and programming the nature, timing, and extent of the audit procedures to be performed;

(d) Coordinating the work to be performed. Plans should be further developed and revised as necessary during the course of the audit." AAS-8 further expounds this principle. According to it, planning should be continuous throughout the engagement and involves

- Developing an overall plan for the expected scope and conduct of the audit; and
- Developing an audit programme showing the nature, timing and extent of audit procedures.

Changes in conditions or unexpected results of audit procedures may cause revisions of the overall plan of and the audit programme. The reasons for significant changes may be documented.

3.2 Objectives of Planning

Adequate audit planning helps to:

- Ensure that appropriate attention is devoted to important areas of the audit.
- Ensure that potential problems are promptly identified;
- Ensure that the work is completed expeditiously;
- Utilize the assistants properly; and
- Co-ordinate the work done by other auditors and experts.

In planning his audit, the auditor will consider factors such as complexity of the audit, the environment in which the entity operates his previous experience with the client and knowledge of the client's business.

The auditor may wish to discuss elements of his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit programme, however, remain the auditor's responsibility.

3.3 Factors

Planning his audit, the Auditor will consider the following factors -

3.3.1 Complexity of the Audit:

The scope of work and reporting responsibilities is analyses in order to determine the complexity of audit.

3.3.2 Environment in which the entity operates:

This enables the Auditor to understand various operational aspects of audit, e.g. extent of computerization, nature of internal controls, general attitude of personnel, etc.

3.3.3 Previous experience with the client:

By analysing the previous year's audit working papers and other relevant files, the Auditor should pay particular attention to matters that required special consideration and decide whether they might affect the work to be done in the current year.

3.3.4 Knowledge of the client's business:

This is required to establish the overall audit plan. The Auditor will be able to

(a) identify areas of special audit consideration

(b) evaluate the reasonableness both of accounting estimates and management representations
(c),make judgments regarding the appropriateness of accounting policies and disclosures.

3.3.5 Discussion with Client:

The Auditor can discuss his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit Programme, however, remain the Auditor's responsibility.

3.4 Sources of Information

The Auditor should obtain a level of knowledge of the client's ness that will enable him to identify the events, transactions and practices that, in his judgment, may have iificant effect on the financial information. The Auditor can gain knowledge of client's "business from:

- Client's Annual Reports to Shareholders.
- Minutes of Meetings of Shareholders, Board of Directors and important Committees.
- Internal Financial Management Reports for current and previous periods, including Budgets, if any.
- Previous year's Audit Working Papers, and other relevant files.
- Personnel responsible for non-audit services to the client who may be able to provide information on natters that may affect the audit.
- Discussions with Client.
- Client's Policy and Procedures Manual.
- Relevant publications of the ICAI and other professional bodies, Industry Publications, Trade Journals,
- Magazines, Newspapers or Textbooks.
- Consideration of the state of the economy and its effect on the client's business.

3.5 Development of Plan

The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.

Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are the act of examining vouchers is referred to as vouching. It is the practice followed in an audit, with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. On these considerations, the essential points to be borne in mind while examining a voucher are:

- That the date of the voucher falls within the accounting period;
- That the voucher is made out in the client's name;
- That the voucher is duly authorized;
- that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and
- That the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

3.6 Audit Programme

It is desirable that in respect of each audit and more particularly for bigger audits an audit programme should be drawn up. Audit programme is nothing but a list of examination and verification steps to be applied set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statement of account produced for audit or on the basis of an appraisal of the accounting records of the client. In other words, an audit programme is a detailed of the accounting records of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to be rendered by the auditor are the other factors that vary from assignment to assignment. Because of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However it becomes a necessity to specify in details in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements. For the purpose of programme construction, the following points should be kept in view:

- Stay within the scope and limitation of the assignment.
- Determining the evidence reasonable available and identify the best evidence for deriving the necessary satisfaction.
- Apply only these steps and procedures which are useful in accomplishing the verification purpose In the specific situation.
- Consider all possibilities of error.
- Co-ordinate the procedures to be applied to related items.

Amplification is not necessary of the above points except the one under evidence: that is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert's knowledge and evidence. This is the primary taks before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonable available in respect of each transaction

3.7 Factors, Advantages and Disadvantages of Audit Programme

3.7.1 Factors

While construction an audit programme, the Auditor should keep the following points in his mind-

- to operate within the scope and limitations of the assignment.
- to determine the evidence reasonably available and identify the best avidence for deriving the necessary satisfaction.
- to apply only those steps and procedures, which are useful in accomplishing the verification purpose in the specific situation.
- to consider all possibilities of error.
- to co-ordinate the procedures to be applied to related items.

3.7.2 Advantages

- It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- Selection of assistants for the jobs on the basis of compatibility becomes easier when the work is rationally planned, defined and segregated.
- Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, the danger is significantly less and the audit can proceed systematically.
- The assistance, by putting their signature on programme, accepts the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.

- It serves as a guide for audits to be carried out in the succeeding year.
- A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

3.7.3 Disadvantages

- The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- The programme often tends to becomes rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.
- Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instructions in the matter is contained therein.
- A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.
- All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observed matters objectively and bring significant matters to the notice of supervisor/principal.

3.8 Audit working papers

3.8.1 Meaning

The audit working papers constitute the link between the auditor's report and the client's records. Documentation is one of the basic principles listed in AAS 1. according to AAS 3, documentation refers to working papers prepared or obtained by the auditor and retained by him in connections with performance of his audit.

The objects of an auditor's working papers are to record and demonstrate the audit work from one year to another. Therefore, working papers should provide for:

a) Means of controlling current audit work;

b) Evidence of audit work performed;

c) Schedules supporting or additional item in the accounts; and

d) Information about the business being audited, including the recent history.

Working papers are varied in nature but the foundation of all working paper can be traced to:

- the basic constitutional document like memorandum and Articles of association, partnership Deed, trust deed, etc.;
- the contents of the minute books;
- the contents of the balance sheet and the profit and loss account; and
- the letter of engagement.

3.8.2 Importance of Audit working papers

I. IT provides guidance to the audit staff regard to the manner of checking the schedules.

II. The auditor is able to fix responsibility on the staff member who signs each schedule checked by him.

III. It acts as an evidence in the court in the court of law when a charge of negligence is brought against the auditor.

IV. It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retained them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

3.8.3 Factors determining Form and Content of Audit

Working Papers:

Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. The form and content of working papers are affected by matters such as:

- Nature of the engagement.
- Form of the auditor’s report.
- Nature and complexity of the client’s business.
- Nature and condition of the client’s records and degree of reliance on internal controls.

- Need in particular circumstances for direction, supervision and review of work performed by assistants.

Working papers should be designed and properly organized to meet the circumstances of each audit and the auditor's needs in respect thereof. The standardization of working papers (for example, checklists, specimen letters, 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. The extent of the documentation is a matter of professional judgement since it is neither necessary nor practical that every observation, consideration, consideration or conclusion is documented by the auditor in his working papers.

3.8.4 Audit File

A permanent audit file normally includes

- Information concerning the legal and organizational structure of the entity. In case of a company, this includes the memorandum and Article of association. In the case of a statutory corporation, this includes the act and regulations under which the corporation functions.
- Extracts or copies of important legal documents, agreements and minute relevant to the audit.
- A record of the study and the evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.
- Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

3.8.5 The Current File

The current file normally includes

- Correspondence relating to acceptance of annual reappointment.
- Extracts of important matters in the minutes of board meetings and general meetings as relevant to audit.
- Evidence of the planning of the audit and audit programme.
- Analysis of transactions and balances.
- A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
- Evidence that the work performed by assistants was supervised and reviewed.
- Copies of communication with other auditors, experts and other third parties.
- Letters of representation or confirmation received from the client.
- Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial information being reported on the related audit reports.

3.8.6 Functions/ Importance

i. It provides guidance to the audit staff with regards to the manner of checking the schedules.

ii. The auditor is able to fix responsibility on the staff member who sign each schedule checked by him.

iii. It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.

iv. It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirement of record retention. Clarification On The Auditor's Rights Where Clients And Other Auditors Seek Access To Their Audit Working Papers.

- Auditing and Assurance standard, "Basic principles governing an audit", states in para6: "The auditor should respect the confidentiality of information acquired in the course of his work and should not disclosed any such information to a third party without specific authority or unless there is a legal or professional duty to disclosed".

Auditing and Assurance standard (AAS), “Documentation”, states: ‘working papers are the property of the auditor. The auditor may at his discretion, make portions of or extracts from his working papers available to his client. “AAS further requires”, inter alia, that the “auditor should adopt reasonable procedures for custody and confidentiality of his working papers.”

- part l of the second schedule to the chartered Accountants Act, 1949, provides that “A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he disclosed information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force.”
- Request are sometime received by the members of the institute, who have/had been performing the duties as the auditor of an enterprises, to provide access to their audit working papers. The request may be made by the clients or other auditors of the enterprise or its related enterprise such as a parent enterprise.
- It is hereby clarified that except to the extent, an auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term ‘auditor’ includes ‘internal auditor’.

3.8.7 Features

As audit working papers are quite useful they should be prepared properly. They should have the following essentials:

- Standard form - they should be prepared in a standard form. The subject matter should be arranged under various heading and subheadings.
- Proper layout – there should be proper design and layout of the working papers. This will bring uniformity into the maintenance of working papers.
- Space for margins – there should be enough space for margin after each note for noting down the auditor’s remarks and decisions.

- proper organisation and arrangement – the working papers should be properly organized and arranged. In other words the working papers should be so organized and arranged that the auditor will be able to locate any particular matter easily.
- Completeness – the audit working papers should be complete in all respects. They should contain detailed information on all essential facts or points.
- Clarity and Accuracy – the working papers should be quite clear and self explanatory. The information contained in the working papers should be accurate.
- Good quality paper – paper of good quality should be used for working papers as they are subject to frequent handling further the paper used should be of uniform and convenient size so that they can be easily filed.

Review Questions

1. What is an Audit Planning?
2. Write the features of an Audit Programme?
3. What is an Audit Work Progress Paper?
4. How to determine the form and content of an Audit?

Discussion Questions

If you are an Auditor, what necessary steps you will follow to prepare an Audit working programme and necessary steps involved in preparing of an audit file

Application Exercises

1. Explain the exceptional features of an Audit File?
2. Explain the necessity of Audit Working Papers?

Vouching and Verification

Learning Objectives

Upon completion of this chapter you will

- Understand the concept of Vouching.
- Enumerate the features of Auditing.
- Knowledge about Test checking.
- Idea about Petty Cash enteries.

Chapter-4 Vouching and Cash Transactions

4.1 Vouching

4.1.1 Meaning

Vouching means the examination of documentary evidence in support of entries to establish the arithmetic accuracy. When the auditor checks the entries with some documents it is called vouching. Vouching is the acid test of audit. It tests the truth of the transaction recorded in the books of accounts. It is an act of examining documentary evidence in order to ascertain the accuracy and authenticity of the entries in the books of accounts.

Vouching consists of comparing entries in the books of accounts with documentary evidence In support thereof. According to Joseph Lancaster "it is often thought that vouching consists of the mere examination of the vouchers or documentary evidence with the book entries. This is, however, quite wrong, for vouching comprises such an examination of the ledger entries as will satisfy the auditor, not only that the entry is supported by the documentary evidence but it has been properly made upon the books of accounts.

From the above it becomes clear that vouching means testing the truth of entries appearing in the primary books of accounts. In short, vouching means to examine the evidence in support of any transaction or entry recorded in the books of accounts. Vouching does not merely see that the entries and transactions are supported by proper documentary evidence. The auditor should be satisfied that they are properly maintained, they are supported by all evidence and they are correctly recorded in the books of accounts.

4.1.2 Voucher

Any documentary evidence supporting the entries in the records is termed as a voucher. Any document, which supports the entries in the books of accounts and establishes the arithmetical accuracy, is called a voucher.

4.1.3 Examples of vouchers:

A bill, a receipt, an invoice, goods received note, salaries and wages sheets, goods inward and outward register, stores records, counterfoil of a cheque book, counterfoil of pay-in-slip book, bank statement, bank pass book, delivery challans, agreements, a material requisition slip, copy of purchase order, minute book, rnemorandum and articles of association, partnership deed, trust deed, prospectus etc. are the examples of vouchers.

4.2 Importance of Vouching

- Ensures genuineness of the transactions
- Enables to know transactions
- Helps to know relevance of the transaction
- Facilitates proper allocation of capital & revenue, expenditure
- Detects frauds and errors
- Decides authenticity of transactions
- Ensures proper accounting
- Compliance with law
- Ensures proper disclosure

The special considerations to be borne in mind by the auditor in the course of vouching.

1. Date of the voucher
2. The name of the party
3. Tick and audit rubber stamp
4. Authorisation by the authorised person
5. Revenue stamp of Re. 1 if it exceeds Rs.5000/-
6. Transaction relates to business
7. Revenue and capital
8. Amounts in words and figure
9. Account head

10.No assistance of member of clients staff to be taken for checking receipts

11. Not to accept receipted invoice

12. Missing vouchers 115

13. Important documents

14. Vouching of cash transaction

15. Proper filing

16. Signature of payee

17. Nature of payment

18. Noting in the audit note book

19. Alteration

20. Voucher control number

4.2.1 Objectives of vouching

The basic objectives of vouching are as under:

1. To ensure that all the transactions are properly recorded in the books of accounts.

2. To see the proper evidence supports all the entries of the transactions.

3 To make it sure that fraudulent transactions are not recorded in the books of accounts.

4 To see that all transactions relating to business are recorded in the books of accounts.

5. To see that all transactions are properly authenticated by a responsible person.

4.2.2 Auditing Techniques

1. To an auditor, auditing techniques are the working tools used and applied for identification and examination of those evidences which have been traced by audit procedures.

2 Distinction: The dictionary meaning of the word 'technique' is the 'method of performance or execution' and that of 'procedure' is 'method of conducting an affair' or 'course of action taken or an act performed'. In other words, we can state that an all-inclusive list of techniques can be outlined (even with an addition of new or improved method or technique), whereas an all-inclusive list of procedures is difficult to be prepared as these are keyed to the objectives to which they relate. Techniques are more or less rigid and limited, but procedures can be many and varied depending on objective considerations for the acts to be performed or actions to be taken. On the same analogy, we can draw distinctions between auditing procedures and auditing techniques as follows:

- An all-inclusive list of audit procedures cannot be prepared as these are addressed to the varying audit objectives; but such list can be outlined for audit techniques.
- Auditing procedures are ways of applying (auditing) techniques to particular phases of a particular audit.
- The procedures (of audit) adopted in different engagements result from the judicious application of the available techniques (of audit).
- Audit procedure, in fact, is concerned with the general assertions like: existence or occurrence, rights and obligations, completeness, valuation or allocation, and presentation and disclosure that may be made regarding an account; whereas audit techniques are concerned with the examination of those evidences which have been traced as such by audit procedures.

4.2.3 Principal Procedures of Auditing:

An all-inclusive list of audit procedures is difficult to prepare. Judgment, with a tempering of experience, remains the basis for the determination of the type and extent of audit procedures. However, the following may be cited as the principal audit procedures:

- Reviewing, testing and evaluating the internal accounting controls relating to inventories, purchases, payroll, sales invoice preparation, stock valuation, depreciation accounting and analysis, routing of invoices, etc.
- Inspecting, counting and calculating the different assets relating to cash, stocks, investment, plant and equipment, furniture; and determining that the inventory is calculated properly at the lower of cost or market price in accordance with generally accepted accounting principles consistently applied; and obtaining confirmation in regard to the validity of debtors and creditors balances, etc.
- Obtaining the proof of accuracy - A copy of final inventory listing can be obtained and its clerical accuracy checked and tested; obtaining the earnings records of employees and checking the same for accuracy with the original copies of appointment-cum-increment letters; Similarly, appropriation of profit and the board's resolutions.
- Reconciling, comparing and confirming - Sales invoices may be reconciled with the total charges to customers. The reconciliation between the cost account records and the books of financial accounts is an illustration. The Bank

reconciliation statement provides a good measure of confirmation. The fact that the inventory belongs to the client and that any lien on the inventory is disclosed properly can be compared and confirmed from the minutes of the board of directors for indications of pledges or assignments.

- Observation and inquiry about any excess, slow-moving, obsolete, or unassailable inventory.
- Accounting of all pre-numbered inventories tags before and after the physical stock-taking.
- Verification as to the evidences relating to the ownership of assets and existence of assets and liabilities, as a part of auditing practices and procedures, is the principal duty of the auditor before he certifies that the assets and liabilities that appear in the balance sheet exhibit 'true and fair view' of the state of affairs of the business.

4.3 TEST CHECKING

4.3.1 Meaning.

Carrying out detailed check of each and every transaction of a large business shall be time consuming for the auditor. In auditing the accounts of a business, every single copy is not usually checked by the auditor; what is usually done in practice is that a representative number of entries of each class are selected and checked and if they are found correct, the remaining entries are taken to be correct. This is known as Test Checking. In those organizations, where satisfactory internal check system is in existence, the auditor need not carry out detailed checking. He may adopt Test checking. It is a system of sampling employed by the auditor for the purpose of reducing the volume of detail checking involved in the audit. If, in Test Checking, he finds that the records checked by him are correct then no further detail checking need be carried out.

4.3.2 Test Checking v/s Statistical Sampling

Selection of items for the purpose of checking can be done in two ways:

(i) Judgment

(ii) Statistical Sampling.

When the judgment method is applied, the method of checking is called test checking. When sampling techniques are applied it is called statistical sampling.

4.3.2.1 Precautions

While adopting the test check, the auditor must take the following precautions:

- Entries selected for test checking must be representative of all transactions.
- The selection of the items should be at random.
- It cannot be adopted in case of vouching the cash book.
- Client's staff should not come to know of the entries selected for test checking.
- Period selected for test checking should differ from book to book and year to year.
- He should not adopt test checking where the law requires thorough audit.
- A number of entries of the first and last month of the year must be checked thoroughly.
- Test should be so devised that a sizeable portion of the work done by each employee is checked.
- 9 Control accounts or impersonal ledger should not be subject to test checking.
- Auditor should select the test independently without regard to the suggestions of the member of the client's staff.
- Bank statement and entries for cash withdrawal and cash deposits should be checked in full.

The extent of the test checking will depend upon the judgment and wishes of the auditor but it must be remembered that time unnecessarily spent in routine checking is a waste of resources. Caution must also be taken to see that the test checking may not become insignificant in extent or automatic and unrepresentative. Test checking will be of no use unless the representative items selected for checking are chosen with great intelligence and imagination.

4.3.3 Advantages

- Volume of work is considerably reduced.
- There is a saving in terms of time, cost and energy

- The extra time available can be utilised for concentrating on areas of considerable importance,
- If done carefully, test checking can be quite effective.

4.3.4 Disadvantages

- The auditor always is under fear whether he has missed out certain important items or that errors have remained undetected while test checking.
- Where the client's staff is aware that the auditor resorts to test checking, the staff may become careless.

4.3.5 Auditor's Liability :

If any errors are found in the accounts the auditor cannot take the shield against the fact that he conducted test check. The auditor should very carefully select the items for test check and ensure on the whole that the accounts show a true and fair view of the Profit/Loss in the case of the Profit & Loss Account and of the state of affairs of the organisation in the case of Balance Sheet.

4.3.6 SURPRISE CHECKS

To avoid audit procedures from becoming routine, mechanical and predictable, surprise checks are desirable. Surprise checks involve visits by auditor to the client's office/factory without prior intimation. The element of surprise is in respect of both time and scope. Items checked during such surprise checks are selected without prior notice to the client's staff.

Such checks are very effective in case of verification of cash, stock, investments, verification of books of prime entry. It helps in ascertaining whether the system of internal control is operating efficiently and thus prevent and detect errors and frauds in accounts.

4.3.7 USE OF TICKS

Ticks are used to keep a control on the work done by the auditor Use of ticks should be done with great care while conducting an audit. Firstly the colour of the tick should be determined so that it is unique and will not be confused with that of the client's staff or internal auditors. Secondly the types of ticks to be used should be selected. The ticks should be placed at the right places so that the matter remains legible and the records do not become shabby. Care should be taken to see, that the use of different ticks does not become known to the clients staff.

4.4 Auditing Overall

Taylor and Perry have defined Auditing in Depth as : “the examination of the system applied within a business entailing the tracing of certain transactions from their origin to their conclusion, investigating at each stage the records created and their authorization”. Audit in depth does not mean 100% checking. It is a detailed examination of the selected transactions from the beginning to the end. Thus, it is used along with test checking. For example, if the auditor has decided to check 25% of purchase transactions, these transactions should be checked in depth. Auditor should check the Purchase Requisition, Tenders, Purchase Orders, Purchase Bills, Goods Received Note, Inspection Note, Purchase Journal, Stock Register, Bin Card and so on. Thus, the auditor should check the purchase transaction right from the beginning to the end. This enables him to evaluate the accounting system and internal controls.

4.5 Audit of Income

4.5.1 Cash sales

1. The cash sales register should be fully checked with the carbon copies of the cash sales bill. Particular attention should be given to first and last month of accounting year.
2. A summary of daily cash should be checked.
3. The auditor should be more careful where cash memos are issued even where cash is not received.
4. A certain representative item should be subjected to vouching in depth to get an idea about reliability of internal control.
5. Salesman’s summary, gatekeeper’s summary and cashier summary should also be compared.
6. Dates of cash sales bills and the date on which the receipt are recorded in the cash book must be the same. If the dates differ, the same should be inquired into.
7. Where cash sales bills are cancelled, all the copies, including original copy dully cancelled, should be kept in record.

8. Where it is a policy of the company to allow a discount, it should be seen that uniform policy is followed.
9. If the sales are made by the salesman, their statements should be verified and reconciliation should be made with the record of cash received.
10. Verify the entries in the cash book and the corresponding effect in sales A/c in the ledger.

4.5.2 Sales return

1. Check the total of Sales Return Journal and find the amount recorded in profit and loss account.
2. Check every item of sale return with the credit notes sent to customer.
3. Check the entry in gate-keeper record for return inward movement of goods and check the internal control. Verify the entry in stock register.
4. Compare the extent of earlier year sales and return with that of the current year.
5. The sales return in the beginning of the year and of the end of the year should be carefully scrutinized.
6. Enquiry should be made if there is a wide gap between the original transaction and the return of goods
7. If the goods are return for unacceptable quality, enquiry about the steps taken after the return of the goods and verify the documentation.

4.5.3 Recovery of bad debts written off

1. Ascertain from the trail balance, the amount under consideration, and it should be taken to Profit and Loss Account.
2. Check the journey entry passed for the same and its authorization.
3. If the amount is received from a party under liquidation through his liquidator/ official receiver, check the letter from the person and check the amount which is received along with the year in which the original depth written off.
4. Trace the amount in the bank statement.
5. Check the correspondence with the party and with the official receiver/ liquidator.

4.5.4 Rental receipts

- Check the nature of the agreement of know the condition on which an asset is given on the rent
- From the original documents, check the rates, periods, mode of payment i.e. cash or cheque.
- Check the outstanding rent for last year and find out which of the receipts are for last year and how much rest still outstanding.
- Check the entries in the cash with pay in slips and the receipts issued.
- Check the outstanding rent at the end of the year and see that provision has been made for the same. Next year's record may be verified to find the receipt of the same.

4.5.5 Interest and dividend received

- First check the income stated in the current year's profit and loss account.
- Ascertain the amount received on account of last year and find the outstanding balance receivable.
- From cash book vouch the entries for income received.
- Check the Tax Deducted at Source (T.D.S.) calculation and verify the effect given in the ledger.
- Compare the income received in total with that of the last year and enquire about any significant variation.
- Get a list of investments and check whether the income on all the securities and investments has been received. If any securities are pledged with bank, get a certificate from bank.
- Ascertain the income for the year, still to be received and check whether provision has been made for the same.
- In case of interest received check the calculations. 9. For interest from bank, verify the entry in the bank statement. For fixed deposits, check whether any F.D has matured or any F.D. newly kept.

4.5.6 Royalties received

The auditor should see the relevant contract and examine the important provisions relating to the conditions of payment of royality. In particular, the rare of royality, mode of calculation and the due dates should be noted. The periodical statement received from the publisher and the calculation of the royality should be checked. If there is any deduction on account of recoupment of royality for the past period, the records for earlier royality receipts should be seen to ensure that the amount of deduction is as per the contract. Royalties due but not yet received should have been properly accounted for.

4.6 Audit of Expenditure Purchase

4.6.1 Purchases Returns

H a part or whole of a consignment of goods found to be defective or of a poor quality, the goods sometime are returned to the supplier and his account is debited. The debit is raised in the Purchase Returns Books, on the basis of Debit Note. The supplier, on receiving the Debit Note, issues Credit Note indicating his acceptance of the debit. Thus on receipt it is attached to Debit Note. All these entries should be verified by reference to the record kept in the Goods Outwards Book or the Stores Record. The original invoices through which the purchases were made also should be referred to for confirming that the nominal account, which was originally debited on the purchases being made, has been subsequently credited on a part or whole of the goods contained in the consignment f having been returned. Where the purchase returns are large, either at the beginning or ': at the close of the year, these might be fictitious, entered to cover bogus purchases recorded earlier. On such a consideration the nature thereof should be ascertained. The rebate in price and allowances granted by the suppliers should be adjusted through the journal on the basis Credit Notes received from the suppliers. These should be verified by reference to the original invoices."?

4.6.2 Salaries and Wages

Payments on account of salaries and wages need to be vouched carefully, since amounts which were either not due or in excess of those due may have been paid by the client. The evidence in support of such payments generally is internal. It can, therefore, be relied upon only if it has been produced in the normal course of business and there exists anefficient system of internal control which could be expected to prevent if from being fabricated.

Therefore, before proceeding to verify payment made on account of salaries and wages, the auditor should examine the internal control procedure as regards the following :

- Appointment, promotion, transfer and discharge of employees.
- Recording attendance of workers engaged on the time basis, as well as particulars of jobs performed by piece workers.
- Arrangement for the preparation of wages and salaries bills and their analysis.
- Sanctioning the disbursement of wages and salaries.
- Arrangement for disbursement of wages and salaries for workers and employees not present on the pay day.
- Custody of the wages records.

He should also verify that the system of internal control provides for the following matters :

- Mechanical recording of attendance of workmen by time recording clocks installed at the factory gate, as well as in each department and the reconciliation of the total labour force with the total of workmen in different departments; also the recording of attendance of the staff departmental in separate registers.
- Preparation of wages and salary bills by members of the staff, who are not connected with maintaining a record of engagement of workers, recording of their attendance or fixation of their wages.
- Rotation of duties of different clerks employed for preparation of wages and salaries bills so that calculations, additions and extensions are not carried out by the same clerk every month. Also, signing of the statement by persons who have prepared them and indication by each person so employed of the nature of work carried out by him.
- Verification of salaries and wages bills in case of newly appointed persons by reference to orders for appointment, promotions or transfer made during each month and of those payable to old employees by reference to old records and on reference to the record of attendance.

- Verification of the amount of total wages paid with the amount adjusted in costing record.
- Checking and authorising the overtime and piece work payment by officers who not associated with the Wages Department.
- Withdrawal by *a* single cheque from the bank of the exact amount of wages and salaries payable as are entered in the wages and salaries bill, depositing in the bank the undisbursed amounts.
- Recording of unclaimed wages and salaries immediately in the Unpaid Wages and Salaries Register, and their subsequent payment on the employee's claim to them.
- Payment of advances in lieu of wages and salaries to persons who go on leave on short notice before the end of the month through the Petty Cash.
- Disbursement of wages in the presence of an official who is in a position to identify the worker and ensure that wages are not being paid to persons other than the workmen except under a proper authority.

4.6.2.1 PETTY CASH EXPENSES

- Identify the persons who handle Petty Cash.
- Verify the ceiling limit of disbursement through Petty Cash.
- Note the limit of Imp rest System.
- See whether petty cash payments are regularly checked by a responsible official.
- Examine Reconciliation Statements prepared regularly for Petty Cash, based on vouchers.
- Verify the Cashbook for the transfer of Cash under Imp rest system to Petty Cash.
- Scrutinise the Petty Cash Vouchers along with Invoices, Bills, Receipts signed by the recipients.
- Trace the postage expenses along with entries in Mail Outward Register. Compare with previous periods and obtain satisfactory explanations for abnormal movements.
- Check the castings of columns, totals and main totals.

- Trace the postings from the Petty Cash Book into the Nominal Ledger Head of Account.
- Verify the petty cash physically available on a certain date, by way of surprise check.
- Examine the Suspense Vouchers / lOU's and ensure that they are reversed within a reasonable time.
- Conduct a Surprise Check of Petty Cash balance and compare the same with the Petty Cash Book.

4.6.3 Travelling Commission Advertisement

Demanded for all items of expenses incurred, except those which are capable of independent verification. As regards traveling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.

The voucher for travelling expenses should normally contain the undermentioned information:

- Name and designation of the person claiming the amount.
- Particulars of the journey.
- Amount of railway or air fare.
- Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station.
- Other expenses claimed, e.g., porter age, tips, conveyance, etc.

If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source. Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified. The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorized by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.

Review Questions

1. What is Vouching? State an Example?
2. Explain the auditing techniques used in Vouching?
3. What are Ticks? Explain its use?
4. What is an Audit of Income?

Discussion Questions

Suppose a tax liability on a company has increases above certain limit? Being an accountant or an auditor, what suggestive expenses would you involve to minimize the tax liability?

Application Exercises

1. What is Test Checking? What precautions are to be taken while adopting?
2. Explain the different expenses that are used most commonly while balancing an overflow account?

Vouching and Verification

Learning Objectives

Upon completion of this chapter you will

- Understand the concept of Asset.
- Enumerate the features of **Empties and Investments**.
- Knowledge about **Patent Rights**.
- Idea about **Contingent Liabilities**.

Chapter-5 Auditing techniques verification

5.1 Audit of Assets

5.1.1 Book Debits/ Debtors

The term 'book debts' suggests particularly amounts recoverable from customers, but in practice it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head. Verification of debtors may be carried out by employing the following procedures:

(a) Examination of records;

(b) Direct confirmation procedure (also known as 'circulation procedure')

(c) Analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor. The general procedure is as under

:

5.1.1.1 Examination of Records

- The auditor should carry out an examination of the relevant records himself about the validity, accuracy and recoverability of the debtor balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.
- The auditor should check the agreement of balances as shown in the schedules of debtors with those in the ledger accounts. He should also check the agreement of the total of debtor balances with related control account. Any differences in this regard should be examined.
- Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the case of significant debtors, the

auditor should also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.

- While examining the schedules of debtors with reference to the debtors' ledger accounts, the auditor should pay special attention to the following aspects :
  - Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.
  - Where the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.
  - Whether transfers from one account to another are properly evidenced.
  - Whether provisions for allowances, discounts and doubtful debts should recognise that even though a debtor may have confirmed the balance due by him, he may still not pay the same.
- The following are some of the indications of doubtful and uncollectible debts, loans and advances :
  - The terms of credit have been repeatedly ignored.
  - There is stagnation, or lack of healthy turnover, in the account.
  - Payments are being received but the balance is continuously increasing.
  - Payments, though being received regularly are quite small in relation to the total outstanding balance.
  - An old bill has been partly paid (or not paid), while later bills have been fully settled.
  - The cheques received from the debtors have been repeatedly dishonoured,
  - The debt is under litigation, arbitration, or dispute.
  - The auditor becomes aware of unwillingness or inability of the debtor to pay the dues, *e.g.* a debtor has either become insolvent, or has closed down his business, or is not traceable.
  - Amounts due from employees, which have not been repaid on termination of employment.
  - Collection is barred by statute of limitation.

- Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorization should be inspected.
- In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.
- The auditor should examine whether contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.

5.1.2 Direct Confirmation Procedure

(a) The verification of balances by direct communication with debtors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. The utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

(b) The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain debtors. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

(c) The confirmation date, the method of requesting confirmations, and the particular debtors from whom confirmation of balances is to be obtained are to be determined by the auditor.

(d) The debtors may be requested to confirm the balances either

i) as at the date of the balance sheet,

ii) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity.

(e) The form of requesting confirmation from the debtors may be either

(a) the 'positive' form of request, wherein the debtor is requested to respond whether or not he is in agreement with the balance shown,

(b) the 'negative' from of request wherein the debtor is requested to respond only if he disagrees with the balance shown.

(vi) The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccuracies or Irregularities.

(vii) The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the debtors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the debtor balances.

(viii) In many situations, it may be appropriate to use the positive form for debtors with large balances and the negative form for debtors with small balances.

(ix) Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous; this may be done on a sample basis. The sample list of debtors to be circularized, in order to be meaningful, should be based on a complete list of All debtor accounts. While selecting the debtors to be circularized, special attention Should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor Should consider accounts in respect of which provisions have been made or balances have been written off during the period under audit of earlier years and request Confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with *nil* Balances. The nature of the entity's business *(e.g.,* the type of sales made or services rendered) and the type of third parties with whom the

entity deals, should also be Considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.

(x) In appropriate cases, the debtor may sent a copy of his complete ledger account for a specific period as shown in the entity's books.

(xi) The method of selection of the debtors to be circularized should not be revealed to the entity until the trial balance of the debtors' ledger is handed over to the auditor. A list of debtors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped, The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to debtors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

(xii) Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of debtors taken as a whole.

5.1.3 Analytical Review Procedures

In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors, loans and advances :

(a) comparison of closing balances of debtors, loans and advances with the corresponding figures or the previous year;

(b) Comparison of the relationship between current year debtor balances and the current year sales with the corresponding budgeted figures, if available;

(c) Comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;

(d) Comparison of current year's aging schedule with the corresponding figures for the previous year;

(e) Comparison of significant ratios relating to debtors, loans and advances with similar ratios for other firms in the same industry, if available;

(/) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available. It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors, loans and advances. The exact nature of analytical review procedures to be applied in specific situation is a matter of professional judgement of the auditor.

5.2 Stock Auditor Duties

5.2.1 Patterns, Dies, Loose Tools, etc.

Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such assets although a careful control over such property is necessary. On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused stock on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum stock account of dies and patterns is also maintained. In other concerns, the cost of tools, dies, etc. purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing stock, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. Care, however, ahould be taken to see that the inventory does not include any worn out or defective articles the life of which has already run out.

5.3 Empties and Investments

5.3.1 Trademarks and Copyright

The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable.

Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights arid verified that renewal fees have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at the cost of each financial period.

The auditor should seg that revaluation has been made on a fair and reasonable basis. Where he finds that any publication has ceased to command sale, he should have the amount of its copyright written off to.

5.3.2 Patent Rights

The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent. It has been purchased; the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are 'alive' and legally enforceable and renewal fees have been paid on due dates by being charged to revenue and to the Patent Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed. If a number of patents are held, a schedule thereof should be obtained. Since the amount paid in respect of each patent should be amortised over its life or a lesser period if its commercial life is shorter, it should be seen that the rate at which the value of each patent is being written off is adequate; its value would be completely written off by the time it would cease to have a commercial value. If the patent has been created by the client by research, experiments and laboratory work, the auditor should ascertain that only the actual cost incurred in the process has been capitalized. However, in all cases the registration cost should be capitalised.

5.3.3 Know-how

Know-how in general is recorded in the books only when some consideration in money or money's worth has been paid for it. Know-how is generally of two types :- (t) relating to manufacturing process; and *(it)* relating to plans, designs and drawings of buildings or plant and machinery.

Know-how related to plans, design and drawings of buildings or plant and machinery is capitalised under the relevant asset heads. In such a case depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalised. Know-how related to manufacturing processes is usually expensed in the year in which it is incurred.

Where the amount paid for know-how is a complete sum in respect of both manufacturing process and related to plans, designs etc. such amount should be apportioned amongst them on a reasonable basis. Where the consideration for the supply of know-how is a series of recurring annual payments as royalties, technical assistance fees, contribution to research, engineering, etc. are charged to the profit and loss account each year.

5.3.4 Plant and Machinery

In the absence of a Plant Register containing detailed particulars of various articles of machinery and equipment, showing separately original cost, addition to and sales from it from time to time. It is not normally practicable for the auditor to verify the existence of such assets. The auditors should therefore insist on a Plant Register being maintained where the value and variety of machinery and plant are substantial in comparison with the total assets of the business.

Where such a register is kept, it is customary to prepare at the end of each year a statement from the Plant Register showing opening balance, sale and addition thereto during the year in respect of various items of machinery and plant. Its total is then reconciled with the balance in the General Ledger.

The cost of addition, if any, is verified with the invoice of machinery supplied together with evidence in respect of other incidental expenses chargeable to the account, including installation expenses. If any of the addition represents the cost of machinery manufactured by the concern with its own material and by its own labour, the basis on which the expenditure has been allocated should be verified. In addition, a certificate is obtained from the engineer responsible for the manufacture of the plant confirming the total cost of manufacture. In case any item or machinery has been scrapped, destroyed or sold the auditor should ascertain that the profit or loss arising thereon has been correctly determined which has either been disclosed in the Profit and Loss Account or credited to the Capital Reserve. In appropriate circumstances, a certificate should be obtained from a senior official that this has been done.

Though it is the duty of the management to ensure that fixed assets are in existence, the auditor also should, periodically, physically examine various items of plant and machinery and other fixed assets, say, once in every three or five years, depending upon the size of the concern. Certain companies, for convenience of inspection attach to each unit of plant and machinery a metallic disc bearing the number at which it is shown in the Plant Register. When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value.

5.3.5 Land and Buildings

Sometimes the two assets are shown together in the Balance Sheet. Nevertheless, their ledger accounts should always be separated particularly in view of the fact that buildings are subject to depreciation while land in general is not. The land holdings should be verified by an inspection of the original title deed to ensure that the land described therein covers all the lands the cost of which is debited in the books of the concern. The auditor however, not being competent to verify the regularity of the title of the concern to the land, is not responsible for doing so. Therefore, generally, a certificate should be obtained from the legal adviser of the client confirming the validity of his title to the land. The auditor should, however, verify that the conveyance deed has been duly registered as required by section 17(1) of the Registration Act, 1908 also that particulars required to be endorsed thereon according to section 58 of the same Act have been duly made and verified. He should, in addition, generally ascertain that *prima facie* the title of the client does not appear to be defective.

If the property is mortgaged, the title deed would be in the possession of the mortgagee or his solicitors. A certificate to this effect should be obtained from them. It should also be ascertained whether there is any second or subsequent mortgage. If ground rents, outstanding for recovery, are included in the Balance Sheet as an asset, the auditor must examine the counter parts of leases granted and also verify that the ground rents which were outstanding for recovery on the date of the Balance Sheet have since been recovered. If there has been any sale of land or building, it should be verified that he amount of profit or loss resulting on sale has been correctly adjusted in the accounts.

The cost of buildings, as is entered in the books, should be depreciated at appropriate rates, depending upon the quality of their structure and the use which is being made of them. The cost of fittings and fixtures to the building should be adjusted separately in the account from the cost of buildings, since these suffer higher rate of wear and tear than the brick and mortar structure and therefore, have to be depreciated at a higher rate. If the values of land and buildings are not separately recorded in the books of account, the same should be separated for purposes of calculation the amount of deprecation. This should be done with the assistance of a valuer, unless the same can be achieved on the basis of some documentary evidence available in the record. Since buildings are continually repaired and there is only a thin margin of differentiation between the expenditure of their improvement and that on repairs, it is necessary for the auditor to scrutinise closely the expenditure on repairs so as to exclude from its expenditure that could legitimately be considered to have added either to the life or the utility of the asset. Such expenditure should be added to their cost while the amount incurred on current repairs is written off.

It is not customary to write up the book values of land and buildings even though their market values have increased but, where this has beendone it will be necessary for the auditor to verify that the appreciation adjusted has been disclosed as required by the law. On the same consideration, no notice need be taken of any fall in the market value of such an asset until the same has crystallized by the asset being sold.

The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows:

(i) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realized for it.

(ii) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinized.

(iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.

(iv) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.

(v) The prices obtained for various plots of land sold should be checked with the pian map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.

(vi) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

5.4 Audit of Liabilities

5.4.1 Outstanding Expenses:

i) Obtain the list of outstanding expenses classified by nature of expenses.

11) Compare current year's outstanding expenses with that of the previous year and enquire the material variations if any.

iii) Verify carefully the estimates of outstanding expenses.

iv) Examine the documentary evidence supporting the outstanding expenses.

v) See that the usual outstanding expenses are paid of by the time of audit.

vi) Make sure that provision has been made for all the usual outstanding, e.g. last Salary, wages, rent etc

v) Examine the correspondence, minute book, etc.

vi) Verify the service contracts made by the company and see that all outstanding arises have been provided for

ix) See that outstanding expenses have been disclosed in the balance sheet under liabilities.

5.4.2 Bills Payable

These are acknowledgements of debts payable. For their verification, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding has been correctly ascertained and disclosed. The steps involved in their verification are:,

(a) Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.

(b) Trace all the entries in the Bills Payable Book into the Bills Payable Account to confirm that the liability in respect of the bills has been correctly recorded.

(c) Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.

(d) Obtain confirmation from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.

(e) Verify that the charge, if any created on any asset for the due payment of bills has been appropriately disclosed.)

5.4.3 Loans

A loan is usually obtained on the basis of *a* loan' agreement. The auditor should refer to it to ascertain the condition on which the loan has been obtained for confirming that all the conditions as regards repayments of the loan, payment of interest thereon and provision of security have been duly complied with. Further, where practicable, he should write to the party to confirm the balance of loan outstanding at the end of the year. A loan can be raised only by a competent authority - in the case of a company by the Board of Directors, in that of a partnership by the partners acting jointly and it that of proprietor concern by the proprietor himself. In the case, of a company there may exist restrictions on the loans being raised in the Memorandum or Articles of Association.

The right of the Board of Directors of a public company or private company which is subsidiary of the public company, under clause *(d)* of sub-section (1) of section 293 of the Companies Act to borrow money is restricted to the aggregate of the paid up capital of the company and its free reserves. However, the company in a general meeting can relax such a restriction by specifying the amount upto which amounts may be borrowed by the Board of Directors. The deed of partnership in the case of a firm may also contain restrictions on the amount of loans that the partners can raise. The auditor should therefore, examine the right of the borrowing authority to confirm that the loan or loans have been raised in the proper exercise of the authority vested in the Board of Directors or the partners as the case may be.

If the loan is secured by a charge on an asset of the company, the document through which it has been created should be inspected and particulars of the assets charged should be verified. In the case of a company, he auditor should further see that particulars of the charge have been duly entered in the Register of Charges and verify that the charges have been registered with the Registrar of Companies. It should further be confirmed that particulars of the charge have been properly disclosed in the Balance Sheet. In view of the provisions contained in sub-section (IA) of section 227, it is necessary for an auditor to find out the purpose or purposes for which the loans have been raised; also confirm whether these have been utilized for the specified purpose or for some extraneous purposes.

5.4.4 Contingent Liabilities

Accounting Standard issued by the ICAI deals with the "Contingencies and Events occurring after the Balance Sheet Date". According to it "a contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence or nonoccurrence, of one or more uncertain future events." The regard has to be to conditions or situation at the balance sheet date , the financial effect of which is to be determined by future events which may or may not occur.

The definition clearly envisages that either there may be contingent losses or contingent gains. As a matter of prudence, contingent gains need not be accounted for in financial statements since this may result in the recognition of revenue which may never be realised. Therefore, we have to consider contingent loss for which corresponding liability should be accounted for in financial statements. Before discussing the accounting treatment of contingent losses, let us understand contingent liabilities in clear terms.

A contingent liability is a possible liability of a presently determinable amount or one indeterminable which has arisen from past dealings or actions that may not become a legal obligation in the future. The uncertainty as to whether there will be any legal obligation distinguishes a contingent liability from an actual liability. An obligation may be a contingent liability when the very basis of the obligation is contested. For example, when a claim is made against a company in respect of infringement of a patent and the companv does not possess a legitimate defence, the liability, though the amount of it is uncertain would be an actual liability, but if the claim is untenable in law, the liability would only be a contingent liability.

Though both of them in actual practice are described somewhat loosely as contingent liabilities, their natures are different. In one case, the liability is admitted but its amount is uncertain while in the other, the very basis of the obligation is denied. There is another type of contingent liability, as in the case of partly paid shares, or in respect of contract for capital expenditure wherein there is an obligation to pay a certain sum of money upon which there will be acquisition of an asset of corresponding value. Contingent liabilities also arise when some of the Bills Receivable as discounted or when guarantees are given for loans granted to the third parties. From the auditing point of view, different types of contingent liabilities are divided into two broad categories, one in respect of which a provision has been made and the other for which there is no provision. AS 4 provides guidance in respect of circumstances when provision has to be made for contingent losses. It states that the amount of a contingent loss should be provided for by a charge in the statement of profit and loss if :

(a) it is possible that at the date of the financial statements events subsequent thereto will confirm that (after taking into account any related probable recovery) an asset has been impaired or a liability has been incurred as at that date.

(b) a reasonable estimate of the amount of the resulting loss can be made.

If disclosure of contingencies is required by following above considerations, then, the following information should be provided:

(a) The nature of contingency;

(b) The uncertainty which may affect the future outcome;

(c) An estimate of the financial effect or a statement that such an estimate cannot be made; The Companies Act, 1956 requires disclosure of following liabilities by way of a note:

(1) Claims against the company not acknowledged as debts.

(2) Uncalled liability on shares partly paid.

(3) An ears of fixed cumulative dividend.

(4) Estimated amount of contracts remaining to be executed on capital account and not provided for.

(5) Other money for which the company is contingently liable.

The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature of each such contingent liability, if material shall also be specified. The apprehended liabilities aforementioned usually are not easy to ascertain unless a comprehensive knowledge in regard to the working of the business is acquired from a study of the Minute Book of Directors, files of correspondence with legal advisers and on collection of information from the officials of the company in regard to indisposed.

Review Questions

1. What is Auditing Technique Verification?

2. Explain the **Direct Confirmation Procedure**?
3. Write short notes on **Investments** and its type?
4. What are Loans?

Discussion Questions

Suppose a tax liability on a company has increases above certain limit? Being an accountant or an auditor, what suggestive expenses would you involve to minimize the tax liability?

Application Exercises

1. What is **Audit of Assets**? Write its types?
2. Explain **Audit of Liabilities in details**?

Vouching and Verification

Learning Objectives

Upon completion of this chapter you will

- Understand the concept of Verification.
- Enumerate the features of **Valuation of Assets**.
- Knowledge about different **Methods of Valuation**.
- Idea about **Verification of Liabilities**.

Chapter-6 Verification and Valuation of Assets and Liabilities

6.1. Meaning of Verification

Spicer and Pegler have defined verification as "it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets". Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available. Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet.

Thus, verification includes verifying:-

1. The existence of the assets
2. Legal ownership and possession of the assets
3. Ascertaining that the asset is free from any charge, and
4. Correct valuation

Of course it is not possible for the auditor to verify each and every asset. It was held in Kingston Cotton Mills case that "it is not part of an auditor's duty to take stock. No one contend that it is. He must rely on other people for the details of stock in trade in hand".

However, as per the decision given in Mc Kesson and Robins case (1939) the auditor must physically inspect some of the assets. Now the auditor has to report whether the balance sheet shows true and fair view of the state of affairs of the company. Hence, he is required to verify all the assets and liabilities appearing in the balance sheet. In case of failure, the auditor can be held liable for damages.

According to the `statement of auditing practices' issued by ICAI, "the auditor's object in regard to assets generally is to satisfy that :-

1. They exist.
2. They belong to the client.
3. They are in the possession of the client or the persons authorized byhim.
4. They are not subject to undisclosed encumbrances or lien.
5. They are stated in the balance sheet at proper amounts in accordance with sound accounting principles
6. They are recorded in the accounts.

6. 2 Object

Following are the objects of verification of assets and liabilities

1. To show correct valuation of assets and liabilities.
2. To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business
3. To find out the ownership and title of the assets
4. To find out whether assets were in existence
5. To detect frauds and errors, if any
6. To find out whether there is an adequate internal control regarding acquisition, utilisation and disposal of assets.
7. To verify the arithmetic accuracy of the accounts
8. To ensure that the assets have been recorded properly.

6. 3 Advantages

Advantages of verification are as under :-

1. It avoids manipulation of accounts
2. It guards against improper use of assets
3. It ensures proper recording and valuation of assets
4. It exhibits true and fair view of the state of affairs of the company.

6.4 Techniques

1. Inspection:

It means physical inspection of the assets i.e. company cash in the cash box, physical inventory, inspection of shares certificates, documents etc.

2. Observation :

The auditor may observe or witness the inspection of assets done by others.

3. Confirmation :

It means obtaining written evidence from outside parties regarding existence of assets.

6.5 Verification of Assets

The term `verification' signifies the physical examination of certain class of assets and confirmation regarding certain transactions. Sometimes verification is confused with vouching but they differ from each other on the nature and depth of the examination involved. Vouching goes to prove the arithmetical accuracy and the genuineness of the transactions, whereas verification goes to enquire into the value, ownership, existence and possession of assets and also to confirm whether they are free from any mortgage or charge. The fact of the presence of any entry regarding the acquisition of asset does not prove that the particular asset actually exists on the Balance Sheet date, rather it purports to prove that the asset ought to exist; on the other hand, verification through physical examination and confirmation proves whether a particular asset actually exists without having any charge on the date of the balance Sheet.

Verification of assets involves the following steps:

1. Enquiry into the value placed on assets;
2. Examination of the ownership and title deeds of assets;
3. Physical inspection of the tangible assets; and

4. Confirmations regarding the charge on assets;

5. Ensuring that the assets are disclosed, classified and presented in accordance with recognized accounting policies and legal requirements.

The scope of verification is wide and consequently verification is an important part of the auditor's duties. An auditor should put all his endeavor to satisfy himself whether a particular asset is shown in the Balance Sheet at proper value, whether the concern holds the title to the asset and the asset is in the sole possession of the concern and lastly whether the asset is free from any charge. If the auditor fails to perform his duty, he will be held liable. In case of London Oil Storage Co. Ltd. Vs. Sear Hasluck & Co. (1904) Chief Justice Alverstone remarked: `It is the duty of the auditor to verify the existence of the assets stated in the Balance sheet and he will be liable for any damage suffered by the client if he fails in his duty.

Besides the legal importance, verification also plays an important role to guard against improper valuation of assets like stock-in-trade which may inflate or deflate the profit position of the concern. Improper valuation of assets may also conceal the actual position of the business as reflected in the Balance Sheet. However, it is not possible on the part of the auditor to physically verify each and every asset because time may not permit him to do so, or he may not have sufficient technical knowledge of the assets concerned.

It was decided in the case of "Kingston Cotton Mills: that it is not a part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for the details of the stock-in-trade. Again, while going through the decision of Mc Kesson and Robins case in 1939, we find that the auditor should physically verify some of the assets.

If possible, title documents like negotiable instruments, shares, debentures, securities, etc. are to be thoroughly examined on the last day of the accounting period. He should satisfy himself that the transactions, if any, having bearing on the Balance Sheet date and date of audit are bonafide and are supported with proper evidence. The auditor is also supposed to verify stock-in-trade with reference to the purchase book, the stock records, the gatekeeper's book, etc. though law does not specially compel him to take stock-in-trade.

6.6 Valuation of Assets

6.6.1 Meaning:

Valuation of assets means determining the fair value of the assets shown in the Balance Sheet on the basis of generally accepted accounting principles. The valuation of assets is very important because over-statement or under-statement of the value of assets in the Balance sheet not only distorts the true and fair view of the financial position but also gives wrong position of profitability.

The valuation of the assets is the primary duty of the officials of the company. The auditor is required to verify whether the value ascertained is fair one or not. For this, he may rely on the technical certificate issued by the experts in the field. Valuation of assets means not only checking value of the assets owned by an organization as on Balance Sheet date, but also critical examination of the value of these assets (comparative analysis of different assets).

The auditor has also to see that the principle of valuation of assets is consistently adopted and is based on established principles of accountancy. For the purpose of convenience, those assets are classified as under to determine their value.

1. Fixed Assets
2. Current Assets or Floating Assets
3. Wasting Assets
4. Intangible Assets
5. Fictitious Assets.

1. Fixed Assets

Fixed Assets are usually valued at `going concern value' which means cost less depreciation. Cost here means purchase price of the assets plus all incidental manufacturing, buying and installation expenses incurred to bring the assets in use. Depreciation is the provision made for the reduction in the value of the assets on account of their usage, natural wear and tear and obsolescence etc. The depreciation provided should be fair, otherwise the value of fixed assets may not be fair. What is a fixed asset depends on the nature of the business organization.

2. Current Assets or Floating Assets

These are usually converted into cash at the earliest opportunity in the process of business activity, e.g. stocks, bills receivables, sundry debtors, etc. Based on conservatism principle, usually current asset are valued at original value (cost price) or market value (realizable value) whichever is lower. Because they are intended to be converted into cash at the earliest possible time, hence what value we may realize is important. This method is adopted to strengthen the financial position of a concern by indirectly providing for expected loss by way of fall in the market value of the assets. This principle is held by the conservatism convention of accounting, i.e. do not expect profits but provide for anticipated losses.

3. Wasting Assets:

Wasting Assets means those which lose their value gradually upon their use, e.g. a mine, a quarry etc. To value these assets firstly we should determine the usefulness of the assets in terms of units of production etc. and as per their actual use the value is to be reduced on proportionate basis. If in a particular period this type of asset is not used then the value may not diminish also. Thus, these assets are to be reduced on the basis of consumption. But sometimes it may be difficult to adopt this method, then the `cost less depreciation' principle may have to be applied.

4. Intangible Assets:

Usually intangible assets like goodwill, patent rights, know how, etc. are valued on cost basis. But if the same are acquired by a non-cash transaction, then the fair market value is to be taken as the value of intangible assets. Auditor should also see the period of time and till it is fully written off, they are shown as assets because they do not have any realizable value. They are to be valued at actual cost less amount written off as depreciation upto Balance Sheet date.

5. Fictitious Assets:

Certain lumpsum expenses giving benefit for more than one year when incurred are written off over a period of time, and till it is fully written off, it is shown as an asset in the Balance Sheet e.g. preliminary expenses, discount on issue of shares etc. These are all ficitious assets because they do not have any realizable value. They are to be valued at actual cost less amount written off upto the Balance Sheet date.

6.6.2 Methods of Valuation

The following are the various principles of valuation of assets

(1) Cost Price: Under this method actual cost of assets are reduced by the depreciation provided. Usually this method is applied to value fixed assets.

(2) Market Value : This refers to the market value of the asset i.e. the price at which the asset is being transacted in the market. This is applied to value the current assets only when this is lower than cost of the asset. Usually market value is adopted to value items having perishable nature.

(3) Scrap Value: Assets which are useless for the enterprise may be sold as scrap in the market. The value for which such assets can be disposed of as scrap, is called as scrap value of assets.

(4) Replacement Value: This represents the value at which the existing assets can be replaced. That means the price to be paid to acquire such type of assets in the market on the date of the balance Sheet.

(5) Realisable Value: The value that can be obtained if the asset is sold in the market i.e. anticipated selling price. Usually, expenses such as commission, brokerage etc. are deducted from it

6.6.3 Auditor's position regarding valuation of assets:

So far as the valuation aspect of audit is concemed, the auditor's position is somewhat different from the other aspects of audit. It has already been pointed out that the auditor is not supposed to have technical knowledge regarding the valuation of assets. Therefore, he has to depend upon the valuation made by the directors, expererts, surveyors, etc, to a great extent. But does it relieve him from liability if certain assets are overvalued or undervalued by the directors, experts or surveyors etc? The reply is definitely no, because the auditor cannot give a guarantee for absolute correctness or the state of affairs when he has to depend upon others, and also where assets are valued according to the estimated depreciation. He has to see that the management tries to show the fairest possible estimate of the position of the state of affairs of the concern. Under these circumstances, the auditor should see that assets are valued according to certain accepted principles of accountancy. He should check the estimation in a reasonable manner. The auditor in any case should thoroughly examine the available papers and documents to arrive at the correct value of assets. In case of a little suspicion as regards the valuation of assets he should probe into the matter.

6.6.4 Distinction between verification and valuation:

1. Meaning : verification establishes existence, ownership and acquisition of assets whereas valuation certifies correctness of the value of assets and liabilities.
2. Time : Verification is done at the end of the year whereas valuation is done during the year.
3. Personnel : Verification is done by auditor whereas valuation is done by the proprietor himself.
5. Evidence : The title deeds, receipts of payments constitute documentary evidence for verification where as certificate given by the proprietor is the documentary evidence for valuation.

6. 7 Illustration of Assets

6.7.1 Cash in hand and at bank :

Cash in hand includes all the following:

(a) Cash in hand :

1. Special care is necessary with regard to verification of cash balances. There can be no certainity that the cash produced for inspection was in fact held by the custodian.
2. For this reason, the cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year without giving notice of the auditor's visit either to the client or to his staff.
3. If there is more than one figure for cash balance e.g. when there is a cashier, a petty cashier, a branch cashier and in addition, there are imprest balance with employees, all of them should be checked simultaneously, as far as practicable, so that the shortage in one balance is not made good by transfer of amount from the other.
4. It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared, containing details and the cash balance counted. If he is absent at the time the cash is being verified, he may subsequently refute the amount of actual cash on hand which may put the auditor in an embarrassing position.
5. If the auditor is unable to check balance on the date of the Balance Sheet, he should arrange with his client for all the balance to be banked and where this cannot conveniently be done on the eve of the close of the financial year, it should be deposited

the following morning. The practice should also be adopted in the case of balance at the factory, depot or branch where cash cannot be checked at close of the year.

6. Should this not be possible, the auditor should verify the receipts and payments of cash upto the date he counts the cash. This should be done soon after the cash balances have been counted. The cash book of the day on which the balance is verified should be signed by the auditor to indicate the stage at which the cash balance was checked.

7. If any cheques, or drafts are included in cash balance the total there of should be disclosed.

8. If there is any rough Cash Book or detail of daily balance are separately kept, the auditor should test entries from the rough Cash Book with those in the Cash Book, to prove that, entries in the Cash Book are correct.

9. If the auditor finds any slip, chit or I.O.U's in respect of temporary advances paid to the employees, included as part of the cash balance, he should have them initialed by a responsible official and debited to appropriate accounts.

6.7.2 Cash in Transit (Remittance in Transit)

1. This refers to amount sent by Branch/Depots/Agents etc. to Head Office but physical cash/cheques not yet received by H.O. or vice versa.

2. Such remittance in transit should be verified from subsequent period cash book/pass book as to whether actually it is received or not.

3. Reconciliation of H.O./Branch Accounts should also be checked.

4. If amount is deposited into bank, pay-in-slip can also be verified.

5. See that entry for remittance in transit is passed by only one party and is reversed in the next year.

6.7.3 Petty Cash

1. Petty Cash in hand should be verified with Petty Cash Book

2. Also check up the balance of Petty Cash Account in General Ledger.

3. Vouch the transaction of last month property to ascertain that ficititious payments are not entered into

4. Some of the points given for verification of cash in hand will be applicable for Petty Cash also.

6.7.4 Bank Balance :

1. To verify cash at bank, the auditor should examine the bank pass book and compare it with the balance as shown by the bank column of the cash book.

2. Check bank reconciliation statement with bank statement / pass book of subsequent period.

3. The auditor should get a certificate regarding the balance at the bank directly from the bank.

4. Ensure that the balance as shown by the cash book is brought into the balance sheet as `Cash and Bank' and not `Balance as shown by the pass book'.

5. The auditor should also see that the `cheque outstanding' and `cheques not yet collected' are genuine and not made up in order to conceal the deficiency. If some of these cheques are more than six months old, he should make inquires, and have them reversed in the books of accounts.

6. Cash in Fixed deposits with the bank can be verified by examining the deposit receipt, or getting a certificate from the banker.

7. If there are more than one bank account such as `Dividend Account'."Interest Account' etc. all such accounts should be checked and the balances should be verified upon the same date. Information regarding their balance should also be obtained from the bank directly.

8. If the bank account shows an adverse balance and the client has deposited any security for the overdraft, the auditor should enquire from the bank the particulars of the security and the amount of the interest charged

6.7.4.1 Bills Receivable

1. The auditor should examine the Bills Receivable Book with the Bills Receivable not matured but in hand on the date of the Balance Sheet.

2. When any bills are in the process of collection the details of the same have to be verified with bank certificates.

3. If the Bills Receivables in hand are many, auditor should make a list of bills for his convenience.

4. If there are any bills that have been discounted, and still not matured, he has to examine the details of the same very carefully and should confirm with the bank because they are to be shown as contingent liabilities by way of a note in the Balance Sheet.

5. While examining the Bills, the auditor has to pay special attention to see that they are properly drawn, stamped and duly accepted.

6. He has to check whether any bills is overdue. If so, auditor should ask for the details of the action initiated, etc. If there are any bills which are doubtful of recovery, he should see whether any adequate provision has been made for the anticipated loss on account of bad debts.

7. He has to see that in case of dishonoured bills, the same is not shown as Bills Receivable. the auditor has also to check up whether noting formalities have been properly complied with or not. 8. In case the auditor has visited his client after the Balance Sheet date, many of the bills due on the Balance sheet date might have matured or honoured. Hence the auditor has to vouch such bills with Cash Book or Pass Book and reconcile the balance.

9. If the bill has been renewed after the Balance Sheet date, then also the value of the original bill due on Balance sheet date should be shown as Bills Receivable and interest on renewed bills properly accounted.

10. If the bills endorsed have been dishonored, the original drawee is to be debited and endorsee is to be credited.

6.7.4.2 Loans advanced

Loans may of different types like :

(a) Loans against the security of land and buildings.

(b) Loans against the security of goods

(c) Loans against the security of stocks and shares.

(d) Loans against the security of insurance policies, and

(e) Loans against the personal security of the borrower.

Therefore, in each case, the duty of auditor in general is as under :

1. Verify whether object clause of the Memorandum provides for granting of such loans.

2. Examining whether a proper loan ledger has been maintained and it is up-to-date or not.

3. Examination of the security lodged against each loan. The loan agreement is to be scrutinized regarding the rate of interest. Due dates of installment, penalty, interest, etc.

4. He should ascertain whether any loan is doubtful of recovery in which case a provision for the expected loss is to be made.

5. Except in case of a banking or finance company, auditor has to ascertain whether the purpose of advancing is connected with business or not. Section 227(4A) of the Companies Act, 1956 requires an auditor to report whether the parties to whom the loans are given are regular in payment of interest and principal and the terms of the loan are not prima facie prejudicial to the interest of the company.

(a) Loans against the security of Land and building

1. The auditor has to examine the mortgage deed, see if the copy has been properly executed and registered in favour of the client.
2. The auditor has to examine the title deeds deposited with the mortage deed.
3. The auditor, if required, has to examine the valuer’s certificate in order to ascertain the value and sufficiency of the security.
4. The auditor has to confirm that the property is properly insured and insurance premiums have been paid in time.
5. The auditor has to examine the title of the Borrower to the property, etc.
6. If the mortgage is a second mortgage, the auditor has to confirm that the same is brought to the knowledge of the first mortgagee. In this case he has to take the acknowledgement of title deeds from the first mortgagee.

(b) Loans against the security of goods.

1. The auditor has to examine the nature of the goods and confirm that the goods are really belonging to the borrower. He should see whether the loan is granted against railway receipt, lorry receipt, dock warrant, godown keeper’s receipt etc.
2. In case goods are stored in the godown, he has to see that the rent of the godown is paid in full and the goods are fully insured.
3. The auditor should examine the value of the goods by comparing them with the present market value. Regarding quality and quantity, he may rely on the inspector’s reports.
4. If the goods are of perishable nature, the auditor has to examine the turnover of the stock of the client.

(c) Loans against the security of stocks and shares

1. He should call for a statement of stocks and shares given as security and confirm that all of them are fully paid up.

2. He should see whether an instrument of transfer is properly stamped and is properly executed.

3. He should see that their value is properly disclosed as per the prevailing market rates.

4. He has to ensure that there is a sufficient margin on the loans advanced.

5. He has to see whether the charge is properly registered or not.

(d) Loans against the security of insurance polices :

1. The auditor should see that the policy has completed at least two years.

2. The auditor should confirm that all the premiums have been properly paid and the policy is in force by examining the latest premium receipt.

3. The auditor should ascertain that due notice of assignment has been given to the insurance company.

4. The auditor should see that the loan has been advanced on the basis of surrender value of the policy as certified by the insurance company.

5. The auditor has to ensure that the premium, if any, paid up by the lender to keep the policy in force is properly debited to the Loan Account of the borrower together with the usual interest.

(e) Loans against the personal security of the borrower

The auditor has to examine the documents like Promissory Note, Guarantor's details and Salary Certificate of the borrower, etc.

6.7.4.4 Sundry Debtors :

Sundry Debtors represents the amount recoverable from the customers for sale of goods or rendering of services.

1. The undermentioned procedure should be applied for verification of `Book Debts' or `Sundry Debtors' after receiving a schedule or list of debtors from the client.

a. Direct confirmation of balances from debtors by sending confirmatory letters.

b. Year-end Scrutiny of ledgers.

c. Verification of the position of debts considered bad or doubt ful.

d. Compliance with legal requirement or presentation.

2. The auditor should arrange to send the letter of confirmation of balances by the client as per client's records and see that the reply of confirmation is forwarded to his office directly. Usually this should be sent within 15 or 20 days of close of the year under the supervision of the audit staff. After the reply is received, the same should be tallied with the balances shown in the Debtors Ledger and difference properly reconciled.

3. After the said procedure is carried out, he should carry out a thorough scrutiny of the debtor's individual accounts. Wherever the number of debtors is very large, Test Checks can be applied.

4. While scrutinizing the ledger, the auditor should focus the light on discounts, returns, cash received, rebates allowed, goods returned etc.

5. On ascertaining the balances of the debtors as genuine and correct, the auditor has to verify the debtors to find out bad or doubtful debts to make a provision for the same. If the debts are bad and irrecoverable or doubtful and they are not provided for properly, the financial statements will not portray a `True and Fair' view. Hence, appropriate provision is to be made by considering the age of the debtor, scrutiny of payments received, management opinion and any other information like financial position of debtors, etc. If the auditor fails in verifying the appropriateness of the provision made, he shall be held liable for negligence.

6. After ascertaining the position of bad or doubtful debts, he should see that the legal requirements of Schedule VI to the Companies Act, 1956 are complied with. For this purpose, the debtors are to be classified as :

(a) Outstanding for a period of more than six months

(b) Other debts.

7. Over and above this, other requirements like debts considered as good and which are fully secured, debts due from the officers, directors, managers of the company, etc., are to be ascertained for disclosure.

8. If the customers have purchased the goods on hire purchase system and some of the instaiments are not due, the same is not to be shown as `stock out on hire purchase'.

9. Likewise, if the goods are sold on `return or approval' basis, such customer cannot be shown as a debtor at the close of the year.

10. Further, whenever there are credit balances in some debtors account, the same are not to be deducted from other debtors debit balances and net balance is not to be shown in the assets side, but former is to be shown as Sundry Creditors.

6.7.4.5 Patent and Trademarks :

1. The ownership of patent rights is verified by inspection of certificate issued for grant of patent, by the prescribed authority.

2. If it has been purchased, the agreement surrendering it in favour of the client should be examined.

3. If there are a number of patents held by the client, obtain a schedule giving the full details thereof or verify with reference to the register maintained by the client.

4. It must be verified that patent rights are alive and legally enforceable and renewal fees have been paid on due dates and charged to Revenue Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed.

5. See that the patents are properly registered in the name of the client only.

6. See that the cost of patent is being written off over its useful period of life.

7. In case the patent is acquired, cost paid for the same and all relevant expenses are to be capitalized.

8. If the patent is created by the client by the research experiments and laboratory work, only the actual expenses incurred for it in the process are to be capitalised.

6.7.4.6 Copyrights

1. The auditor has to examine the written agreement of assignment alongwith the royalty paid to the authors etc., for such copyrights.

2. He has to see that such assignments are properly registered.

3. If the client is the owner of many copyrights, the auditor should ask the client to prepare a schedule of copyrights and get the detailed information to confirm that the same is shown in the Balance Sheet.

4. Regarding the value of copyrights, it should be remembered that this asset has no value in the long run. Hence, value is determined on revaluation basis and period of copyrights.
5. If any copyrights does not command the sale of any books, then the same should be written off in such year. The auditor has to verify the same in detail.

6.7.4.7 Know-how :-

1. Know how is recorded in the books only if it has been paid for. If it is developed in house, it cannot be capitalised. The auditor should keep his in mind while verifying know-how.

2. Know-how can be of two types :

(a) Relating to manufacturing process – The auditor should ensure that the expenditure is written off in the year of payment itself.
(b) Relating to design, plans of plants, building etc. - The auditor should ensure that the expenditure is capitalized and depreciation is charged on the capitalized figure.

In case lumpsum payment is made for both types of know, both the types should be segregated on a reasonable basis. Under the Income-Tax Act, cost of Know-how can be deducted subject to the rules laid down. The auditor should keep this fact in mind while computing the tax liability for the year under audit.

6.7.4.8 Investments :

Investment may be a share certificate, government bond certificate, government loan certificate, debenture certificate, etc. For verification of such securities, the following procedure is adopted.

1. Obtain a schedule of investments in hand at the beginning of the audit period. Obtain the details of description of investments together with distinctive number of face value, date of purchase, book value, market value, rate of interest, date of payment of interest or, date around which dividend is declared, etc., with also the details of interest or dividend received along with tax deducted at source.
2. Add to the above list, purchase made during the year and delete the investments sold during the year with all the above details.
3. Balance this schedule and compare the balance with general ledger and Balance sheet.
4. Check the market value of investments with reference to stock exchange quotations or other suitable method, on Balance Sheet date and see that the values are disclosed in the Balance sheet.

5. Inspect the certificates or securities physically on the Balance Sheet date.

6. Compare the income received with amount due and adjust the accrued income.

7. Confirm the uncalled liability on partly paid shares held as investment shown as contingent liability by way of a note to the Balance Sheet.

8. See that adequate provision is made for any shortfall in the book value of investment shown in the Balance Sheet.

9. See that, regarding the investment in subsidiaries, disclosure requirement of section 212 of Schedule VI of the Companies Act, 1956 are complied with.

10. For investment in the capital of partnership, the partnership deed and copy of accounts of partnership firms, is to be verified. Also adjust the share of profit and loss for the partnership period.

11. Investments which stand in the name of persons other than that of the company are to be confirmed with appropriate sanction.

12. For investment lodged with others as security or lying with banks or share brokers, obtain a certificate from the parties concerned.

13. In case of application money paid for shares which are still to be allotted, that fact is to be specially disclosed in the Balance Sheet.

6.7.4.9 Leasehold Property :

Normally the lease or right to use the property is granted for certain number of years. At the expiry of the period of lease, the rights go back to the original lessor. Various steps involved in the verification of leasehold rights are stated below.

1. Inspect the lease agreement to ascertain the amount of premium paid, period of lease, other terms and conditions, like maintenance, insurance, etc.

2. See that the lease is properly registered with the Registrar because a lease for a period exceeding one year is not valid unless it has been granted by a registered document.

3. Ascertain those conditions, the failure of which might result in the forfeiture or cancellation of lease, and see whether they have been properly complied with.

4. See whether sub-lease is valid as per lease agreement, in case if it is granted, by referring to sub-lease agreement.

5. See that the premium paid and acquisition expenses of lease are being amortised (written off) over the period of lease adopting a suitable basis.

6. In case, any provision is to be made under the dilapidation clause for payment on the expiry of the term of lease, see that the same is properly and continuously provided.

7. In case of leasehold land, if any building is constructed by the lessee, see the position and ascertain the correct method of presentation of such expenditure for disclosure in the Balance Sheet.

6.7.4.10 Goodwill

1. Whenever the company has purchased or acquired a running business and has paid for it an amount, in excess of the book value of its net assets, the excess is called `Goodwill'. It can be verified from the vendor's agreement and the auditor has to see whether there is a specific sum which is paid or whether it is the excess of price paid over the tangible assets and see that it is properly recorded.

2. When the company has written up the values of all its assets on a revaluation and has raised a Goodwill Account in the books, the Goodwill appears in the Balance Sheet. In this case, the auditor has to see the basis of valuation and get satisfied about the same. If he is not satisfied, the fact should be reported to the shareholders.

3. He has to see that such excess is credited to a Capital Reserve or Revaluation Reserve and no dividend is being declared from it.

4. He has also to see the disclosure requirement of Schedule VI and ensure that the fact are disclosed for 5 years subsequent to the date of revaluation.

5. Sometimes, Goodwill which is written off earlier may be brought back in the books of account to adjust the debit balance of Profit and Loss account. In this case, the auditor should investigate the fact and satisfy in full before approving such method of creating Goodwill. He should also refer to the board resolution. In case he is not satisfied, the fact should be reported to the shareholders. 6. If Goodwill has been created by any other means, the auditor should see that all relevant facts are properly disclosed and are supported by documentary evidence.

6.7.4.11 Plant and Machinery:

1. Now-a-days as per provision of Section 227(4A) of the Companies Act, 1956 every company is required to maintain a Fixed Asset Register showing full particulars including cost, location, depreciation, details of purchase, expenses capitalised, etc. Therefore, the

auditor should ask for such a register maintained by the client and see that all items of plant and machinery are recorded properly giving full details.

2. As per the provision of the same section, all fixed assets are required to be physically verified by the management. Therefore, the auditor should enquire whether such physical verification was undertaken or not. If yes, he should ask for necessary papers pertaining to the same. If there is any discrepancy, reasons for the same should be asked.

3. Any new purchase made during the year are to be verified with reference to purchase invoice and other papers regarding installation of the same.

4. Total value of plant and machinery as shown by Fixed Asset Register should tally with ledger account maintained in the financial books.

5. Where any item of plant and machinery is sold, scrapped or transferred the auditor should check relevant entries for the same and verify that they are removed from the Fixed Assets Register.

6. The auditor should verify that adequate depreciation is provided on all items of plant and machinery and method of depreciation is consistently followed from year to year.

7. Auditor should see that the entire plant and machinery stands in the name of the client and are free from any charge or encumbrances. If plant and machinery is mortgaged, then he has to verify that the documents are properly executed and mention of mortgage is made in the Balance Sheet.

6.7.4.12 Furniture and Fixtures :

1. The auditor has to see that a proper record showing quantitative details of furniture and fixtures owned by the client is maintained.

2. The auditor has to see that all expenses incidental to the purchase of furniture and fixtures is capitalised along with the purchase price paid for it.

3. The auditor has to enquire whether the furniture and fixtures have been properly insured or not.

4. The auditor has to see that adequate provision for depreciation on furniture and fixtures is made.

5. The auditor if possible can go for physical verification of furniture on test check basis or he can rely on the management certificate to that effect.

6. He has to further see that any damaged or unusable furniture, if existing, is fully written off in the books.

6.7.4.13 Freehold Property (Land & Buildings) :

1. The auditor has to examine the title deeds of the property owned by the client and confirm that the same is freehold.

2. If the property has been purchased during the year, the auditor has to examine the correspondence with the broker, or solicitor in details.

3. When a building has been constructed on the freehold property, the same is to be verified from builder's bill or architect's certificate.

4. Where the title deeds are deposited with the mortgagee on a mortgage, then a certificate from him to that effect is to be obtained for verification.

5. If the title deeds are deposited with the bankers or solicitors for safe custody, the auditor should get a certificate from them to confirm the fact.

6. If required, the auditor should ask the solicitor of the client to confirm the validity of the title deeds relating to the property.

7. The auditor has to see that the conveyance of the property is in the name of the client and the same is properly registered.

8. The auditor has to ensure that the property is properly insured.

9. The auditor should see that separate account for land and building is maintained. Because on land, usually no depreciation is provided.

10. In case there is appreciation of land and buildings value by revaluation, the auditor has to see the basis of revaluation and confirm that the same is properly disclosed in the Balance Sheet, to comply with the generally accepted accountancy principles and also the provision of Companies Act, 1956.

6.7.4.14 Motor Cars :

1. In respect of motor vehicles mileage or usage method is better because the time of total mileage that the particular vehicle will give, can be ascertained without much difficulty and the mileage in a particular year can also be known, so proportionate cost of the asset can be written off over the mileage traveled. For example, if the total mileage of a vehicle costing Rs. 80,000 is 1,60,000 miles and in a year suppose 15,000 miles are traveled, then the depreciation for that vehicle would be:

15000

8000 x --------------------- = Rs. 7,500

160000

2. Where number of motor cars is large, it would be advisable if the client maintains a motor vehicle register. Where no such register is maintained, the balance of Motor Car account in the General Leger should indicate the registration number and cost of each vehicle.

3. The auditor should examine the registration book to see whether the description agrees with the details given by the client. The auditor should see that the person in whose favour registration is made holds it on behalf of the client and gives a confirmation that he holds it and there is no charge on it.

4. Many a times, vehicles are purchased by the client for the purpose of employees who pay a certain sum of money every month from the salaries. When all the money has been paid, the client transfers the car in the employee's name. The auditor should check the relevant records for recovery made and the transfer price.

5. Sometimes cars are owned by employers and given to employees and cost of maintenance is borne by the client and the auditor in these cases affirms that whenever the client owns a car, he should provide depreciation on it.

6. Similarly, when the car is sold as scrap to the employees the auditor should compare the written down book value with the scrap price realized and see that the balance is charged to revenue account.

6.8.4.15 Loose Tools, Patterns, Dies, etc.

Auditor's duties with regard to the verification and valuation of such assets may be stated as follows:

1. Since the duration of the usefulness of such assets is very low, there is no need of maintaining separate accounts for each of them. The auditor in this case should see whether proper supervision has been exercised over these assets, as there is every possibility of pilferage of such small assets.

2. The auditor should collect a list of small tools, dies, moulds, rigs, etc. from a responsible officer and examine the same very carefully. He should also see that such a list has been certified by a responsible officer.

3. As regards the valuation of small tools, the auditor should see that in the case of the concern which manufactured its own tools, the tools are not to be valued in excess of the cost.

4. Generally, these types of assets appear to be either lost or consumed very rapidly. So the conventional method of depreciation should not be applied in their cases. The suggestion as given by Montgomery in this connection may be stated. "Charging the cost of replacement of such items to maintenance in lieu of depreciating them is usually a satisfactory altemative". The auditor should see whether the above mentioned suggestion has been accepted or not.

6. The auditor should also see whether such an asset has been properly shown in the Balance Sheet.

6.7.4.16 Assets Acquired on Hire Purchase Agreement

1. Assets purchased on hire purchase basis:

The auditor should take the following steps:

a) Verify the minutes book of board meetings and see that there is proper resolution passed by the board to approve the purchase of asset on hire purchase books.

b) Examine the hire purchase agreement carefully and note down the terms and conditions of the agreement.

c) Ensure that installments due are paid and the charges are charged against current profits.

d) See that the depreciation is charged on cash price of the asset.

e) See that the amount due to the hire vendor is shown as a current liability on liability side.

f) For new purchase, check bill agreement or other supporting.

6.7.4.17 Live Stock

a) Check entries in Live Stock Register and compare them with ledger and financial statement.

b) Book value in respect of animals which are dead or not useful should be written off.

c) See whether management has taken physical count on regular occasions.

6.7.4.18 Stores and Spare Parts

1. The asset known as stores and spare parts consists of materials which are means for consumption in the business and not for resale. Lubricants, dyes, fuel, etc., are examples of stores, while spare parts of machinery are preserved to maintain it in proper order.
2. The asset as such should be clearly shown in the Balance Sheet.
3. The auditor should obtain an inventory of stores and spare parts duly certified by a responsible officer. He should count the stock himself and thus verify the existence by personal inspection, if possible.
4. It is to be remembered that the stores consumed are debited to the Manufacturing Account and spare parts used are debited to the Machinery Account.
5. The asset is to be shown at cost price in the Balance Sheet. It is not a depreciable asset by use and provision for depreciation is not necessary.
6. However, the loss on account of breakage or waste on being worn out should be duly written off.
7. The asset should be revalued annually.

6.7.4.19 Contingent Assets

Some of the examples of contingent assets may be the following :

(a) Option to apply for shares in another company on favourable terms;

(b) Refund of octroi paid for goods sent out later on;

(c) Claim for money from a previous endorser of a bills receivable discounted but might be dishonoured;

(d) Uncalled share capital;

(e) Legal action for infringement of a copyright, etc.

Usually, contingent assets are not shown at the foot of the Balance Sheet on the assets side and the Companies Act does not require the contingent assets to be disclosed as such.

6.7.4.20 Remittance in Tansit

The question of remittance-in-transit will arise where there is a head office and branch office and head office sends cash for meeting the day-to-day expenses. If at the end of the year probably in the last week, cash might have been sent by the head office but not received by the branch office or alternatively branch might have sent its collection from customers to the head office but the head office might not have received it before the end of the accounting period, then it is a case of “Remittance in Transit.”

(a) To verify this item the auditor should call for the bank statements of head office and branches and reconcile them. Any cash received by the branch or head office in the first week of the new accounting year might have been in transit on the last day of the previous year. For the purpose of recording such cash in the balance sheet an entry is passed in the books as

Cash in transit A/c Dr.

To Branch A/c. or Head Office A/c.

(b) Verify cash in transit from the Cash Book/Pass Book or subsequent period as to whether actually it is received or not.

(c) Check the statement of Reconciliation of H.O. and Branch Accounts.

(d) Verify pay-in-slip, if the amount is deposited into the bank.

(e) See that the entry passed as per item no. (a) is reversed in the next year.

6.7.4.21 Miscellaneous Expenditure

According to Schedule VI of the Companies Act, 1956,

Miscellaneous Expenditure (to the extent not written off) are as follows :

(a) Preliminary Expenses.

(b) Commission or Brokerage on underwriting or subscription of Shares or Debentures.

(c) Discount allowed on issue of Shares or Debentures

(d) Interest paid out of capital.

(e) Development and other expenditure

(a) Preliminary, Expenses

1. These are the expenses incurred for creating or incorporating a company i.e. legal expenses for drafting Memorandum of Association, Articles of Association, Stamp fees, etc.
2. Auditor should check the prospectus or the statement in lieu of prospectus for amount of preliminary expenses.
3. Contract with promoters, vendors, underwriters should be checked.
4. Board of Directors authorization for payment of expenses should be checked. Receipts should be obtained for payments.

5. Actual expenditure for preliminary expenses should not exceed amount mentioned in prospectus or statement in lieu of prospectus. Such excess should be approved by shareholders in general meeting.

6. Preliminary expenses can be written off against Share Premium Account (Section 78), if any.

7. Preliminary expenses should be written off in a reasonable number of years (usually 3 to 5 years).

8. Preliminary expenses to the extent not written off should be shown under Miscellaneous Expenditure, on the Asset side of the Balance Sheet.

9. Preliminary expenses written off during the year should be shown separately in the Profit & Loss Account.

(b) Commission or Brokerage on Issue of Shares or Debentures:

1. Such commission should be allowed by Articles of Association.

2. Rate of commission should not exceed 5% of the share issue price or rate prescribed under Articles of Association, whichever is lower.

3. Rate of commission should not exceed 2.5% of the debentures issue price or rate prescribed under Articles of Association whichever is lower.

4. Amount of commission payable should be mentioned in prospectus or statement in lieu of prospectus.

5. Copy of contract should be filed with the Registrar.

6. However in case of brokerage (i.e. percentage of commission payable to brokers who deal in shares and procuring of shares,etc.) above mentioned restriction of 5% or 2.5% is not applicable.

7. Actual payment should be authorized by Board of Directors.

8. Commission on issue of shares or debentures can be written off against Share Premium Account (Section 78) if any.

9. Such commission or brokerage should be written off in a reasonable number of years (usually 3 to 5 years).

10. Commission or brokerage to the extent not written off should be shown under Miscellaneous Expenditure on Asset side of the Balance Sheet.

11. Commission or brokerage written off during the year should be shown separately in Profit & Loss Account.

(c) Discount allowed on Issue of Shares or Debentures:

Auditor should verify :

1. Such discount should be approved by ordinary resolution in general meeting as well as it should be authorized by the Company Law Board.
2. Rate of discount cannot exceed 10% unless higher percentage is approved by Company Law Board.
3. Such shares cannot be issued within one year from certificate of commencement. Further such shares should be issued within two months from the date on which issue is sanctioned by Company law Board.
4. Prospectus should contain particulars regarding discount.
5. Discount on issue of shares or debentures can be written off against Share Premium Account (Section 78) if any.
6. Such discount should be written off in a reasonable number of years. (usually 3 to 5 years).
7. Such Discount to the extent not written off should be shown under Miscellaneous Expenditure on Asset side of the Balance Sheet.
8. Discount on issue of share or debenture written off during the year should be shown separately in Profit & Loss Account

(d) Payment of interest out of Capital (Section 208)

Auditor should verify :

1. Such interest is allowed when construction work started by the company cannot be completed for some years, e.g. construction of plant and machinery, etc.
2. Such interest should be authorized by Articles of Association or by special resolution. Further the Central Government approval is necessary for payment of such interest.
3. Rate of interest cannot exceed 4% p.a. It cannot be paid after the half year immediately succeeding half year in which construction work was completed.
4. Actual payment of interest should be checked with entries in bank statement.
5. Payment of interest out of capital according to Section 208 does not amount to reduction of capital.

6. Such interest can be debited to cost of construction or it can be treated as deferred revenue expenditure which would be shown under `Miscellaneous Expenditure'.
7. In case such interest is transferred to `Miscellaneous Expenditure', it should be written off in a reasonable number of years (i.e. 3 to 5years)
8. The amount written off during the year should be shown separately in Profit & Loss Account.

6.8. Verification of Liabilities

The verification of liabilities implies an enquiry into the nature, extent and existence of liabilities. It involves ensuring the following:

1. That all the liabilities have been clearly stated on the liability side of the Balance Sheet.
2. That all the liabilities related to the business itself.
3. That they are correct and authorized.
4. That they are shown in the Balance sheet at their actual figures.

It is an important duty of an auditor to verify the liabilities appearing in the Balance Sheet of the company. The object of verification of liabilities is to ascertain whether there is any improper inflation or deflation of values or improper creation of an imaginary liability in the books. This form of manipulation is done in most cases to inflate or deflate the profits of the concern and thus make the position of the business appear stronger than what actually is, to create a secret reserve. As a result of such manipulation, the Profit and Loss Account and the Balance Sheet prove to be incorrect and thus the Balance Sheet does not exhibit a true and fair view of the state of affairs of the concern. So, the auditor must take all possible steps to ensure that all liabilities are recorded properly in the books of accounts of the business. It is advisable that the auditor should, besides verifying the liabilities as shown in the Balance Sheet, get a certificate from the management that all liabilities of any nature have been included in the books of accounts and the contingent liabilities have been shown by way of a foot-note to the Balance Sheet or have been provided for.

6.9.1 Illustration

(i) Share Capital : Though capital is not a liability of the company the auditor is required to verify it so that he can report on the genuineness of the balance sheet. The duties of the auditor can be enumerated as follows :

1. If it is the first year of existence of the company

(a) He should examine the Memorandum of Association and Articles of Association

(b) He should check the Cash Book, Pass Book, Director's Minute Book to find out the number of shares, the various classes of shares, the amount received thereon and the amount due from the shareholders.

(c) If some shares have been allotted to the vendors, he should examine the agreement between the vendors and the company.

(d) In case shares are issued at a premium he should ensure that the premium on issue should be credited to a separate account.

(e) Allotment and call money should be verified.

(f) He should check the forfeiture and reissue of shares, if any

(h) He should ensure that all the relevant provisions of the Companies Act are complied with.

(2) If it is not the first year of the company

(a) The share capital would be the same as in the previous year unless there are some alterations or addition by way of fresh issue or otherwise. He should ensure that the relevant legal provision are fulfilled.

(b) Similarly for reduction of share capital, he should see the provisions of the Act as specified in Sec. 100.

(c) In case bonus shares are issued, the auditor should check whether the permission from concerned authorities is taken, whether proper resolution is passed and whether the capitalization entries are correctly passed.

(d) In case rights shares are issued the auditor should check the bank book, bank statements. He should ensure that the required resolutions are passed and that the permission of the concerned authorities is taken, with particular reference to Sec. 81.

(ii) Reserves and Surplus : Reserves may be general or specific in nature. Sinking fund, Capital Redemption Reserve, Reserve for Contingencies are specific reserves. Auditor's duty in verification of reserves Is as follows :

(1) He should check the Profit and Loss Appropriation account for transfer to reserves, to see the provisions of transfer of profit to reserve are complied with.

(2) He should check the board resolution for transferring the profit to the respective reserves.

(3) He should ensure that the movement in the reserve accounts i.e. additions to/deductions from previous year's balance are properly disclosed as per the requirements of the law.

(4) Ensure that reserves are properly utilized as required by law.

(5) See that the reserves are properly disclosed in the balance sheet as per the law.

(iii) Loans Borrowed

For verification of loans, the auditor should consider the following points:

1. The auditor should examine the Memorandum and Articles of the Company to find out the powers of the Company to borrow money.
2. The auditor should examine the agreement and correspondence regarding the loan.
3. The auditor should vouch the receipts of cash on account of loan, with the receipts issued in respect of the loan and the corresponding entries in the cash book.
4. The auditor should examine the certificate of registration issued by the Registrar of Companies, if the loan has been secured by mortgaging any property.
5. The auditor should vouch the payment of interest with the counterfoils of the receipts issued to the vendors and the corresponding entries in the Cash Book.
6. He should also check the repayment of loan with the counterfoils of the cheque books, the bank pass book and the cash book. In addition to the above, the auditor may ask for a confirmatory letter from the party who has advanced the loan to ensure that the interest on loan is not due and the recoupments of loan are recorded in the books of account correctly. In the case of bank overdraft, the agreement with the bank and the security offered should be examined by the auditor.

(iv) Trade Creditors:

1. The auditor should ask for a schedule of creditors and check the same with the purchase ledger as that is already examined by him.

2. He should ensure that all purchase made during the year especially at the end of the year are included in the accounts of the creditors.

3. In case of suspicion about any creditors, the auditor with the consent of the client can ask the statement of account to be sent and verify the same by scrutinizing ledger accounts.

4. He should see the various debtis given for discount, goods returned etc, and confirm that the same are genuine.

6. The auditor should ask for the reason for not paying any overdue creditors.

(v) 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.

1. Liabilities on Bills Receivable discounted and not matured:

If the bills receivable are discounted with a bank and the money so received from it is made use of, the entire money will 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 distinctly shown in the Balance Sheet by way of a footnote.

2. Liabilities for calls on partly paid shares :

The amount called on shares held and paid should be verified from the cash book and the liability for the amount uncalled should be ascertained.

3. Liability under a guarantee :

The auditor should ascertain the liability for a guarantee given by the client for a loan or overdraft to his friend or partner. In case of non payment of such a loan, the possible liability should be ascertained.

4. Liability for cases against the company not acknowledged as debts :

It is a liability in a disputed case where damages may have to be paid. A contingent liability should be ascertained and a note should be made at the foot of the Balance Sheet.

5. Liability in respect of arrears of Dividend on Cumulative preference Shares:

The auditor should examine the Articles of Association which should lay down rules in this regard and due provision should be made for such a liability.

6.8.2 Auditor's duty :

The auditor should very carefully check the various contingent liabilities named above. There may be some such liabilities for which no provision has been made in the books but merely a note has been made at the foot of the Balance Sheet, e.g. Bills Receivable which have been discounted and which have not matured at the date of the Balance Sheet, arrears of fixed cumulative dividends, etc. For liabilities in respect of which provision has to be made in the Balance Sheet, viz a suit, etc., the auditor should examine such cases and ascertain the amount to be specifically reserved for the purpose. The auditor should examine the Director's Minute Book, correspondence made with the legal advisers and the information obtained from the officials of the business. He has to ensure that proper provision has been made for all such liabilities and if he is not satisfied, he should mention the fact in his report. It is to be remembered that the requirements of the Companies Act regarding the contingent liability should be complied with in the Balance Sheet on the liabilities side.

(i) Provision for Taxation :

1. In case of a limited company it is compulsory that the taxation provision is to be made. But it cannot be ascertained accurately because the final liability on this account can be known only when the assessment is completed. Therefore, a fair estimate for providing this liability is necessary. Hence, the auditor has to verifty the calculation done to arrive at the provision expected to be made.
2. However, when finally the assessment is over, the auditor should see that the excess or short provision is properly adjusted in the books.
3. Where any appeal is pending and the liability challenged, the same is a contingent liability. Hence the same is to be properly ascertained and disclosed in the Balance sheet.

(ii) Employees' deposits :

Normally, in commercial and industrial ventures, the employees who deal with cash or stores are required to deposit cash security as a safeguard against some possible mis-appropriation or pilferage. Sometimes, the employees instead of paying cash, endorse trustee securities in favour of the employers. It should be remembered in this connection that :

1. Such a security in cash or in securities should be deposited separately in the bank.
2. It should be shown distinctly on the liabilities side of the Balance Sheet.

3. He should verify the amount of deposits by reference to the certified schedule received from the client.

(iii) Reserve for Bad and doubtful Debts

The verification should be done as follows:

1. The auditor should obtain a certificate from some responsible officer of the business and then check the amount provided for bad and doubtful debts.
2. The schedule of debtors should be compared with the balance of ledger accounts to ascertain the possible amount of bad and doubtful debts.
3. The adequacy of such a reserve has specially to be checked. He should examine the nature, the circumstance of a particular business and the necessary rules in practice in this connection.

(iv) Bills Payable :

The auditor should verify the Bills Payable in the following ways:

1. The Bills Payable Book should be checked with the Bills Payable Account.
2. The Bills Payable already paid should be checked from the Cash Book and the returned Bills Payables should be examined.
3. To verify the Bills Payables which have not yet matured at the year end, the auditor should examine the Bills Payable book and should check the Cash Book of the succeeding years to see whether any payment has been made in respect of such bills. In case of any doubt, the auditor may ask the drawers for the confirmation of the bill.
4. The auditor should see if any charge has been created on the assets of the concern by accepting the bill and he should see that the facts are disclosed in the Balance Sheet.

(v) Proposed Dividend:

1. The auditor should ensure that the dividend proposed complies with the provisions of the Companies Act, the decisions of the Court, especially in the matters of provision for depreciation, distribution of capital profits, transfer to reserves etc.
2. The auditor should verify the board resolution and the entry in the Profit and Loss Appropriation account.
3. The auditor should ensure that as per the requirements of the Companies Act, 1956 gross dividend has been provided for.
4. To ensure completeness, the auditor should cross-check the names in the dividend list with those in the register of shareholders.

(vi) Outstanding Expenses:

The auditor should obtain a certificate from a responsible officer to the effect that all the outstanding expenses have been included in the current year's accounts. The amount paid on various accounts should be verified from the entries in the Cash Book. It should be ensured that the outstanding expenses included that part which is unpaid at the date of the Balance Sheet. The following points should be noted.

1. He should carefully note that all expenses, e.g. rent, rates, interest, wages, salary, audit fee, legal expenses, etc., have been accounted for in the books.
2. He should check entries in the books passed on the basis of invoices to ensure that they are not related to the year under audit.
3. He should compare all the paid and unpaid expenses of the current year with those of the previous year to see that there is not much difference.
4. It should be ensured that all outstanding wages and salaries have subsequently been paid.

(vii) Bank Overdraft

The verification of bank overdraft will be on the same lines as that of loans and advances. The difference is that it is the financial assistance obtained from the bank. The auditor should examine the Bank Pass book and call for a statement of mortgaged assets. It is to be remembered that the assets so mortgaged should be clearly stated as such in the Balance Sheet.

(viii) Debentures:

1. The auditor has to examine the provisions regarding the power of the company to issue debentures as contained in Memorandum and Articles of Association.
2. If the debenture is issued as mortgage debenture, he has to verify the registration certificate issued by the Registrar.
3. He should carefully examine the terms of debentures issue as contained in Trust Deed and ensure that the same have been properly complied with.
4. The auditor should vouch the cash received on this account with the cash book.
5. The auditor should verify whether the interest on debentures is paid or provided, properly at regular intervals invervals or not.

6. In case the debentures have been redeemed during the year the same is to be confirmed with the Minutes of Board of directors. Counterfoils of the cheque books. Bank Pass book and Cash book, returned debenture certificate etc.

7. If the debentures have been issued as a collateral security, then he should see that the fact is properly disclosed in the Balance Sheet.

(ix) Unclaimed Dividend

For verifying unclaimed dividend, the auditor should follow the following procedure.

1. See that the Bank Account from which dividend is paid is properly reconciled. See that dividend account is opened for each year to avoid mistake of one year's dividend getting mixed up with next year's dividend. See that no entries remain in these Bank Accounts reconciliation like accounts debited by bank but not accounted in books, etc. because then the Unclaimed Dividend shown in the books will be wrong.

2. See that wherever dividend is declared on shares, where calls are in arrears and directors have decided to adjust the dividend payable against calls in arrears, the appropriate entries have been booked.

3. See that a full list of shareholders who have not claimed dividend is prepared. This is necessary firstly to prove that there are no mistakes commited while reconciling the Bank Account and secondly to prove the accuracy of the Member's Register. The auditor should compare this list with the Member's Register to see that unclaimed dividend for every shareholder is matching with the number of shares held by him as per Share Register. This will also disclose if any dividend is paid to a shareholder who has already transferred his shares provided he has not encashed his dividend warrant.

5. See that if the statutory time limit of 3 years is over, the money being in Unclaimed Dividend Account is transferred to the Central Government with details of shareholders who have not claimed the dividend.

(x) Calls in Arrears :

The auditor should verify Calls in Arrears as under :

1. Find out whether calls in arrears are arising on account of capital issued during the year or is continuing on account of capital issued in earlier years.

2. If it is on account of capital issued during the year, see that correct amount has been arrived at towards call in arrears by referring to the application form money paid towards application, shares allotted, total share money payable, calls made, calls money payable

and calls paid. For this he will have to conduct share allotment audit to arrive at all the relevant data.

3. In case calls are in arrears from earlier years, see that reminders have been sent to the shareholders for payment of calls. If the Board has decided to charge interest on such calls in arrears see that reminder contains the request to pay the calls in arrears with interest. If any part of the calls in arrears has been received during the year on which interest was payable see that such call moneys are received with interest.

4. If any transfer application has been received for shares on which some calls are in arrears, see that no transfer has been affected without arrears having been paid first.

5. If the Directors have declared dividend, see that dividend payable on such shares is proportionately reduced and if the directors have decided to appropriate dividend on such shares where calls are in arrears see that dividend is not physically paid out but appropriate accounting entries crediting calls in arrears and debiting dividend payable is passed.

6. See that, if the Board has passed any Resolution forfeiting shares on which calls are in arrears, the same is reflected properly in the accounts by passing of necessary entries and such shares are not continued to be shown as part of capital at full value and calls in arrears continued to be deducted there from.

(xi) Fixed Deposits :

The auditor should keep in mind the following points while conducting a fixed deposit verification –

1. Fixed Deposits should be accepted according to Section 58A of Companies Act, 1956 and Reserve Bank of India's guidelines.

2. Fixed deposits from director for less than six months (but exceeding 3 months) should not exceed 10% of paid up share capital and free reserves.

3. Total fixed deposits should not exceed 25% of paid-up share capital and free reserves.

4. Fixed deposit should not be accepted if the period exceeds 36 months.

5. Interest on fixed deposits can not exceed 15% p.a.

6. Brokerage can be paid subject to limits mentioned below.

(a) Upto 1 year – not to exceed 1% of amount of deposits.

(b) 1 to 2 years – not to exceed 1.25% of amount of deposits

(c) 2 to 3 years – not to exceed 1.50% of amount of deposits.

7. Liquid assets should be maintained at not less than 10% of deposits maturing 31st March.

8. Receipts should be issued to the deposit holders.

9. Fixed Deposit Register should be maintained.

10. Return of fixed deposits should be sent to the Registrar before 30th June. In case it is not sent, auditor should mention it in the Auditor's Report as per Section 45 MA of Reserve Bank of India Act, 1934.

11. Interest accrued but not due should be provided and it should be shown under Current Liabilities.

12. Fixed Deposits received along with accrued and due interest would be shown under `Unsecured Loans'.

Review Questions

1. Write short note on Verification?
2. Explain **Verification of Liabilities with example**?
3. What is an **Outstanding Expenses**? Explain?
4. Explain the **Auditor's duty in Verification**?

Discussion Questions

Suppose you are an Auditor, what precaution will you take while asking your client to deposit case for issuing of fixed deposits?

Application Exercises

1. What is **Calls in Arrears**? State its features?
2. Which items will you cover under **Illustration?** Explain it in details?

Company Audit

Learning Objectives

Upon completion of this chapter you will

- Understand the concept of Company Auditor.
- Enumerate the duties of an Auditor.
- Knowledge about **Appointment of First Auditor**.
- Idea about **Disqualification of Auditors**.

Chapter-7 Company Auditor

7.1 Introduction

Accountants and auditors are important positions inside any company. These are filled by men and women responsible with ensuring that an organization is efficiently run in order to achieve performance and success and make continuous progress along the years.

The role of an auditor is to evaluate several aspects of the business, or of ongoing projects and even employees. Another responsibility of auditors is to ensure the efficient use of material and human resources in order to serve an organization best. Auditors are in charge of checking the financial records of a business also. Following these roles, he or she must make evaluations and recommend solutions for correcting unprofitable aspects or procedures inside the company.

An auditor's role grants him the position of taking care of the goings on inside a business. He or she must preside over transactions that take place inside the company and with other entities, as well as to make risk analysis when it comes to it. The auditor job means that the person employed on this position will dissect every aspect of a business. Auditing offers many opportunities for lucrative careers.

Auditors that work for a specific company or business are referred to as internal auditors, while those that are hired for a specific project and work outside the company are external auditors. They are either freelance professionals or associated with accounting firms or financial planning firms.

External auditors have the benefit of being unbiased toward anything that goes on inside the organization, whether it is other employees, management or office politics. They are able to conduct an audit without being influenced by anything in any way. On the other hand, internal auditors have better insight know everything that goes on within the company and can make decisions taking into account every department or service and the implications it has.

7.2 Duties

The duties of auditors depend on the terms of the articles as well as on the statutory provisions. Their duties are summarized as follows:

1. To make a report to the member:

The principal duty of the auditors is to make a report to the members on the account examined by him and on every balance sheet, profit and loss account and on every other document annexed thereto which would be laid before the general meeting during his tenure of office. The report must state whether in his opinion and to the best of his information and according to the explanations given to his, the said accounts give the information in the manner required by this act, and give a true and fair view in the case of the balance-sheet, of the state of the company's affaires as at the end of its financial years and in the case of the profit and loss account, of the profit or loss for its financial year.

The companies' (amendment) act 1965 has imposed new duties upon auditor. Section 227 (I-A) requires the auditor to enquire into the following matters:

a) Whether loans and advances make 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 by book entries are not prejudicial to the interests of the company.

c) Where the company is not an investment company 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 purchases 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 any shares have been allotted for cash, whether cash has been actually received in respect if such allotment and if no cash has been actually received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

The auditor's report must relate to the accounts examined by the auditor. It must contain statements on certain specified matters. In the report the auditor shall state:

(a) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purposes of his audit.

(b) Whether in his opinion proper books of accounts as required by the act have been kept by the company so far as appears from his examination;

(c) Whether proper return adequate for the purposes of his audit have been received from branches not visited by him;

(d) Whether the report on the accounts of any branch office audited by a person other than the company auditor has been forwarded to his and how he has dealt with the same in preparing his report;

(e) Whether the company's balance-sheet and profit and loss account are in agreement with the books of accounts and returns.

Where any of the above mentioned questions is answered in the negative or with a qualification the auditor's report must state the reason for the answer.

Only the person appointed as the auditor of the company or where a firm is so appointed, only a partner in the firm practicing in Indian, may sign the auditor's report. The auditor's report must be read in the general meeting and must be open to inspection by any member of the company.

In addition to the above duty of an auditor in connection with the audit of the annual accounts, the auditor has to perform the following duties:

1. Duty to certify the statutory report:

The auditor has to certify the correctness of the statutory report as far as:

a. The number of the shares allotted by the company, whether against cash or for any other consideration;

b. The total amount of cash received by the company in respect of all the shares allotted, distinguishing as aforesaid;

c. An abstract of the receipts of the company and the payments made there out;

2. Duty to certify profit and loss account in a prospectus:

Section 56(I) provides that a prospectus issued by an existing company shall contain a statement of profits and losses, year-wise company shall contain a statement of profits and losses, year-wise for the previous five years showing the rate of dividend paid each year and a statement of assets and liabilities of the company. Such a statement has to be certified by the auditor of the company.

3. Duty to assist investigators:

An auditor is bound to assist the inspectors in every possible way when the affairs of the company are being investigated.

4. Duty as to declaration of solvency in members voluntary winding up :

In case of members' voluntary winding up of a company, a copy or the report of the company's auditor on the profit and loss account and the balance-sheet for the period commencing from the date by which the last account was prepared and up to the date of declaration is to be sent along with the declaration of solvency. In the said report a statement of the company's assets and liabilities for the same period should also be included.

The statutory duties of the auditors as stated above can be expanded but they cannot be curtailed either by the articles of association or by the directors of the company.

7.2.1 Duty of reasonable care:

An auditor must act honestly and with reasonable care and skill; otherwise he may be sued for damages. Further, it is the duty of an auditor to verity with skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective or to approach his work with a foregone conclusion that there is something wrong. He is a watch-dog but not a blood hound. He is justified in believing tried servants of the company and in assuming that they are honest provided he takes reasonable care.

On the other hand if there is anything calculated to excite suspicion, he should probe it to the bottom, and he must not confine himself merely to the task of verifying the arithmetical accuracy of the balance-sheet but should ascertain by comparison with the books of the company that it was properly drawn up so as to show the correct financial position.

An auditor must satisfy himself that the securities of the company in fact exist and are in safe custody. This duty is discharged by their making personal inspection of the securities in question.

Auditors are not concerned with the policy of the company or whether the company is well or ill managed. It is not his duty to give advice, either to directors or shareholders, as to what they ought to do.

7.3 Appointment of First Auditor

The main points regarding appointment of the First Auditors of a company are given in Section 224(5):

1. The first auditors of a company can be appointed by the board of directors within one month of the date of registration/ incorporation of the company by means of a resolution.
2. The auditors so appointed shall hold office until the conclusion of the first Annual General Meeting.
3. If the Board of Directors fails to appoint the First Auditor within one month, the company in a general meeting is empowered to make the appointment.
4. The auditors so appointed by the Board of Directors may be removed by the company at a general meeting which may appoint any other auditor.
5. An auditor cannot be appointed as First Auditor simply because his name has been stated in the Articles of Association.
6. The First Auditor need not sent an intimation by the company of their appointment and the First Auditor are themselves not required to inform the registrar of Companies about their acceptance/ refusal of such an appointment.

7.4 Appointment of Subsequent Auditor

The main points regarding appointment of Subsequent Auditor of a company are given below:-

1. Section 224(1) empowers the shareholders to appoint auditor at each Annual General Meeting by means of a resolution.
2. Upon an auditor being appointed in the Annual General Meeting, the company is to give intimation thereof to the concerned auditor within seven days of the appointment.
3. On receipt of the intimation from the company about his appointment, the auditor is required to send a written communication to the concerned Registrar of Companies within 30 days in form no.23B indicating whether he has accepted or declined the appointment.
4. The auditor so appointed shall hold the office from the conclusion of one Annual General Meeting to the conclusion of the next Annual General Meeting.
5. The auditor will be guilty of professional misconduct if at any time he accepts audit more than the specified numbers of audit assignments of the company u/s 224 of the Act.

7.5 Removal of Auditor

1. The first auditor appointed by the directors may be removed by the shareholder in the first Annual General Meeting. Such Auditors can even be removed from their office before the expiry of their term of office without the permission from the Central Government.

2. In any other case, auditor can be removed only by the company in General Meeting after obtaining previous approval from the Central Government

3. An Auditor, on the expiry of the terms of his office may not be reappointed and thus removed from his office.

a) Resolution requiring special notice (of fourteen days) should be passed at the general meeting.

b) On receipt of notice of resolution, company shall send copy of the notice to the retiring auditor.

c) On receipt of notice, retiring auditor can send written representation of a reasonable nature to the company which should be informed to the members. Normally company has to circulate such representation to the shareholders, unless it is received too late. A notice of resolution also should be circulated, stating a fact of such a representation. If the representation in not circulated for being received too late or because of the default of the company, auditor can insist it to be read at the meeting.

d) However, company or any other person like directors or shareholders have a right to file a petition with Company Law Board (CLB) to refrain the

e) Auditor from making such representation, if it is to secure needless publicity or is defamatory. In such a case, on the direction of the CLB, copies need not be sent or read at the meeting. These provisions apply to removal of the auditors appointed by Central Government also.

4. The other relevant provisions are that if a new auditor is appointed, the company should within 7 days, inform the new auditor. The new auditor should inform the Registrar within one month of such intimation received about his decision and he should also communication with the retiring auditor in this matter, is he accepts the post.

7.6 Disqualification of Auditors

The provision regarding disqualification of auditor is governed by section 226 of the Companies Act, 1956. 1. Section 226(3) The following persons are not qualified for appointment as auditors of a company:

a) A body corporate an officer or employee of the company

b) A partner or employee of an officer or employee of the company

c) A partner or employee of an officer or employee of the company

d) A person who is indebted to the company for more than Rs. 1000

OR

A person who has given any guarantee or provided any security in connection with the Indebtedness of any third person to the company for more than Rs. 1000.

e) A person holding any security (a security would mean an instrument carrying voting rights) of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000. 2. Section 226(4)

A person is not eligible for appointment as an auditor of any company if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company and vice- versa. 3. Section 226(5) If an auditor after his appointment, becomes subject to any of the disqualification mentioned in section 226(3) and section 226(4), he shall be deemed to have automatically vacated his office.

Review Questions

1. What is a Company Auditor?
2. Explain the function of an Auditor in the Company?
3. What rules are to be followed by the company in order to appoints its Auditor?
4. Explain the provision of disqualification of an Auditor?

Discussion Questions

A company ABC has to appoint its fresh auditor for its accounting checking, so what will be the guidelines that they have to follow in order to keep an Auditor?

Application Exercises

1. What is the role of First Auditor?
2. Which basic steps a company has to follow while disqualify its auditor? Explain?

Company Audit

Learning Objectives

Upon completion of this chapter you will

- Understand the concept of Company Audit.
- Enumerate the types of Audit.
- Knowledge about **Appointment of Auditor**.
- Idea about **Disqualification of Auditors**.

Chapter-8 Company Audit

8.1 Introduction

An audit is a professional, systematic examination and verification of security and information management controls. It is performed against a defined set of criteria to determine the adequacy and effectiveness of data security, integrity, and availability. These criteria need to be drawn from policy, procedure, regulatory requirements, and industry best practices.

The audit process must be designed to help an organization protect itself and its people from such things as litigation, identity theft, loss of intellectual property, and so on. The audit process gauges how well this is accomplished and provides situational awareness. The audit process needs to be a major feedback mechanism for your organization's security program. You must perform regular audits to truly understand the current state of your data custodial process and procedures. The auditing process is a technical detective control.

The process must always begin with your company's audit policy and procedure. These provide the framework for conducting an audit. Begin by reviewing the policy, procedures, and standards for currency and relevance. If these are out-of-date, ensure that a new Risk Assessment/Vulnerability Assessment (RA/VA) is completed. An audit that is looking for the wrong things with outdated standards is no more effective than an antivirus program with out-of-date definition files. The audit procedure defines the audit types, scope, frequency, and methodology.

8.2 Types of Audits:

An audit is a process to help an organization protect itself and its people from litigation, identity theft, loss of intellectual property, and so on. The audit process tests how well this is accomplished. It is a professional, systematic examination, and verification of security and information management controls. It is performed against a defined set of criteria to determine adequacy and effectiveness of data security, integrity and availability policy and procedures.

The purpose is to provide situational awareness. Perform regular audits to understand the current state of your data custodial process and procedures. The purpose of a security audit is to analyze traffic patterns and compare them with a standard. The standards include policy, procedure, regulatory requirements, and industry best practices. The process is designed to help an organization understand its current condition and how to improve it if deficiencies are discovered.

• Security of information

• Compliance (HIPAA, SOX, PCI-DSS)

• Internal—Typically conducted by in-house personnel. If this is used, a periodic
audit by an outside auditor can add value, perspective, and validate internal findings. Often the opinion of an outside auditor carries more weight with executive management and the board of directors than do internal audits.

• External—Performed by an outside entity, independent of the organization. This
requires a specific statement of work and service level agreement (SLA). • Remote site/office audit—Ensure policies have been implemented at all company sites—no weak links in the security program. Opportunity to train local site personnel in security awareness program.

8.3 Auditors Appointment

8.3.1 Appointment of First Auditors

A Board meeting should be conveyed within one month of the date of registration of the Company and a Resolution should be passed appointing and fixing remuneration of the first Auditors who shall hold office until the conclusion of first Annual General Meeting (AGM).

The person being appointed as the first Auditors of the Company should not hold any security carrying voting right of that Company. If the Board fails to appoint first Auditors within one month after the registration, then a General Meeting should be held by issuing 21 days notice with relevant Explanatory statement and Auditor can be appointed by passing ordinary resolution.

In case of listed Public Limited Company for such appointment of Auditors in General Meeting, 3 copies of the notice and copy of the proceedings of the General Meeting should be forwarded promptly to the Stock Exchange where such shares of the Company are listed.

8.3.2 Appointment of Retiring Auditors

An Auditor is normally being reappointed at the A.G.M. Therefore, the Company should obtain a written certificate from the Auditor that the re-appointment, if made, will be in accordance with the limits specified in Section 224(1B).

Though the limits as specified in section 224(1B) does not apply to a Private Company after Companies (Amendment) Act, 2000, as per Institute's Code of Ethics the limit continues to apply, which should be borne in mind while accepting the audit.

The Company convening the AGM, (after issuing notices in writing at least 21 days before the meeting along with the Explanatory statement), should pass ordinary resolution in the A.G.M. appointing the retiring Auditor as Auditor of the Company, who shall be holding the office till the conclusion of next A.G.M. and the resolution should also contain details of his remuneration.

Three copies of the notice and proceedings of A.G.M. should be sent to the Stock Exchange, where such shares of the Company are listed.

Instead of Ordinary Resolution, a Special Resolution by 3/4th majority is required to be passed in case of a Company in which not less than 25% of the subscribed share capital is held singly or in any combination by Government Company/Central Government/State Government, Nationalised Banks/Insurance Company/Financial Institution, etc.

The Company should intimate the Auditor about his appointment within 7 days of the passing of the Resolution appointing him.

The Auditor should inform the Registrar of Companies in Form No. 23B within one month of the receipt of the intimation from the Company that he has accepted or refused to accept his appointment.

8.3.3 Appointment of Branch Auditor

The accounts of the branch office of a Company, if any, is required to be audited by the Company's auditor appointed u/s. 224 or by a person qualified for appointment as auditor u/s. 226. Where the branch office is situated outside India, the accounts to be audited either by the Company's auditor or by an accountant duly qualified to act as an auditor in accordance with the laws of that country. The shareholders may authorise the Board to appoint the branch auditors in consultation with the Company's auditors. However the

Central Government is empowered to make such rules as it may deem fit for the matters specified in relation to the branch auditors.

Notwithstanding that the accounts of the branch are audited by a person other than the Company's auditor, the Company's auditor shall have the right to visit the branch and have access to the book and accounts and vouchers of the Company. However, in case of a banking Company having a branch outside India, the Company's auditor may have right to access of copies and extracts of the books of account.

The branch auditors shall have the same powers and duties as that of Company's auditors. The branch auditor shall forward his report to the Company's auditors.

8.3.4 Appointment of an Auditor other than a Retiring Auditor

The Company must receive a Special Notice from a member/shareholder not less than 14 days before the ensuing A.G.M. indicating his intention to move a resolution for changing the existing Auditor of the Company and for appointing another Auditor in his place.

The Company must send forthwith a copy of such notice to the existing auditor of the Company.

A certificate in writing should be obtained from the proposed new Auditor to the effect that his appointment, if made, will be in accordance with the limits as specified in Sec. 224(1B).

The Company must issue notice in writing at least 21 days before the date of A.G.M. stating about the Special Notice received and proposing the ordinary resolution for change of the Auditor along with Explanatory statement.

The retiring Auditor has a right to make representation either in writing to the Company or orally at the A.G.M. If the representation is received from the Auditor the same should be enclosed along with notice. If the representation could not be sent along with the notice for being received late, it should be sent later at any time, being reasonable time, but before the A.G.M.

In case it is not possible to send special notice and representation in the notices of the A.G.M., then the Company should inform the shareholders by advertisement in newspaper having appropriate circulation or by any other mode as allowed by the Articles of Association not less than 7 days before such A.G.M.

However, if a copy of such representation by the retiring auditor is not possible to be sent as aforesaid, because they were received too late or because of the default of the Company, such written representation shall be read out at the meeting. This is without prejudice to the right of the Auditor to be heard orally in the A.G.M. But in certain circumstances the Company Law Board can exempt the Company from sending or reading out such representation of the retiring Auditor on the application either of the Company or of any of the persons, who claims to be aggrieved.

Three copies of such notices to be forwarded to the Stock Exchange, where such shares of the Company are listed.

- The Company should then hold a General Meeting and pass a Resolution.
- Only after such Resolution is passed in the A.G.M. the new Auditor shall be considered as duly appointed in place of the Retiring Auditor.
- The new Auditor should inform the concerned Registrar of Companies in Form No. 23B about his accepting the appointment within one month from the receipt of Intimation of his appointment from the Company.

8.4 Removal of an Auditor

An Auditor is appointed at the A.G.M. and he holds the position till the conclusion of the next A.G.M. However, circumstances may permit a Company to remove the Auditor before the expiry of his term.

For this, Board of Directors should convene a meeting after giving notice to all the Directors, to approve the draft of the application to be sent to the Central Government for the removal of the Auditor.

Such an application is to be made to the Regional Director of the concerned Region seeking approval of the removal of the Auditor before the expiry of his term. Such application should be made on the letterhead of the Company mentioning the details and reasons. Necessary formalities of enclosing documents, payment of fees, etc. are to be complied with.

The Regional Director after considering the merit of the application and based on facts and circumstances of the case, may approve such removal of the Auditor. On receipt of such approval a meeting should be called of Board of Directors to fix the date, time, place and agenda of the Meeting where the previous Auditor will be removed and a new Auditor will be appointed in his place.

Notice should be issued in writing at least 21 days before the date of A.G.M. and ordinary resolution should be passed appointing new Auditor in the place of previous Auditor at the A.G.M.

8.4.1 Code of Ethics

Part I of the First Schedule of Chartered Accountants Act, 1949 deals with the Code of Ethics of the Profession of Chartered Accountancy. As per clause 8, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he accepts the position of Auditor previously held by another Chartered Accountant without first communicating with him in writing.

It is important to remember that every client has an inherent right to choose his Auditor. But underlying objective of this clause is that besides the professional courtesy the member being removed must have an opportunity to know the reasons for the change in order to be able to safeguard his own interest, the legitimate interest of the public and the independence of the existing Auditor. Therefore the new Auditor, who is being appointed in place of Retiring Auditor should not accept the audit unless he communicates with the previous Auditor and ensure that such communication in writing has reached to the Retiring Auditor. Therefore, a letter under U.P.C. is not considered as effective communication and the same should be sent by Registered Post Acknowledgement Due letter or hand delivery. The professional reasons for not accepting an Audit in place of the Retiring Auditor would be:

- Non-compliance of the provisions of sections 224 and 225 of the Companies Act;
- Undercutting of fees;
- Non-payment of undisputed audit fees by auditees (other than in case of sick units) for carrying out the statutory audit under the Companies Act, 1956 or various other statutes;
- Issuance of a qualified report
- 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 auditors.

- Where at an annual general meeting no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy.
- The remuneration of the auditors includes any sum paid by the company in respect of the auditors expenses.

8.5 Appointment of Auditors for Listed Companies

The Council of ICAI have accepted the recommendation of Securities & Exchange Board of India (SEBI) that audit of listed companies shall be carried out by the auditors who have undergone Peer Review Process and have been issued Peer Review Certificate by the Peer Review Board

The above decision is effective for accounting periods commencing on or after April 1, 2009. Consequent to the above decision, all the auditors of Listed Companies are required to undergo Peer Review Process and get Peer Review Certificate issued from the Peer Review Board.

Review Questions

1. What is a Company Audit?
2. Is Company audit really required? Explain?
3. What rules are to be followed by the company in order to appoint its Auditor?
4. Explain the provision of disqualification of an Auditor?

Discussion Questions

A company ABC has to appoint its fresh auditor for its accounting checking, so what will be the guidelines that they have to follow in order to keep an Auditor?

Application Exercises

1. Write in brief about the nature and features of auditing a Company?
2. Which basic steps a company has to follow while disqualify its auditor? Explain?

Auditor's Report and Cost Audit

Learning Objectives

Upon completion of this chapter you will

- Understand the concept of Audit Report.
- Enumerate the features of an Auditor Report.
- Knowledge about Report Content.
- Idea about Audit Opinion.

Chapter-9 Auditor’s Report

9.1 Introduction

Audit report is the means by which the auditor communicates the results of his work to the shareholders in particular, and to other users in general. Often, it forms an integral part of the financial statements. The report, written by the audit firm, and signed by a partner of the firm, expresses an expert opinion on the credibility of the financial statements.

9.2 Example of Audit Report.

ABC ROYAL INDIA LTD.

The Report of the Auditors

To the Members

We have audited the financial statements on pages 2 to 10 in accordance with approved auditing guidelines and standards. We obtained the information and explanations which we considered necessary for our audit.

9.2.1 RESPECTIVE RESPONSIBILITIES

In pursuance of the provisions of the law, the Directors have the responsibility to prepare the financial statements and present same to the auditors and we as auditors have the responsibility to examine and express our opinion on the financial statement.

9.2.2 BASIS OF OPINION

Proper books were kept, and adequate returns received from branches not visited. To the best of our knowledge, and according to the information and documents presented to us, the financial statements are in agreement with the books and records, and comply with the provisions and guidelines of the Companies and Allied Matters Act, 1990, and the Statement of Accounting Standards issued by NASB.

In our opinion, the financial statements give a true and fair view of the state of the company's affairs at 31st December xxxx and its balance sheet as at that date.

J. ABC & Co.

Certified National Accountants

Punjab, India.

Details of Audit Report

9.2.2.1 Identification of the Users: The audit report first identified its intended recipients, the shareholders of ABC India. Ltd. Other users are left out. This clearly reminded the members of the public that the auditor is directly responsible to the shareholders, and not to any other parties that may decide to use the audit report. However, he does not absolve the auditor from blame and liability if his report is misleading and such third parties incur financial loss resultantly.

9.2.2.2 Identification of the Subject Matter: The subject of the audit is the company's financial statement made up primarily of the annual restriction of the documents examined to the profit statement, balance sheet and funds statement should not be taken as a denial that other parts of the financial statement fall within the scope of the auditors report, and the auditor has the duty to ensure that the information therein are not inconsistent with the contents of the accounts.

9.2.2.3 State the Auditors Opinion: The end product of the audit process, the opinion function in the audit report is the auditor's judgment on the credibility of the financial statements.

9.2.2.4 Report on other Responsibilities and Rights: These are whether proper books have been kept, and whether the information required by the auditor were obtained, and whether adequate returns were obtained from branches not visited.

9.2.2.4 Other Reports: The auditor is permitted to make reference in his report to any matter which, although does not imply qualification, will aid the user in having a better understanding of the report. In report on such unusual events, care is required in order not to give the misleading impression of negative report.

9.2.2.5 Judgment in Audit Report: The auditor report is not in any way a guarantee or certification, nor is it a statement of undisputed fact. Rather it should be construed as an expression of personal belief. The Companies Act 1990 stipulates this view, provided the auditor has carried out an adequate examination of all the evidence he regards necessary to the opinion he expresses. In the circumstances, he shall not be held responsible for any other than an opinion. The implication is that the auditor can not be held negligent if he makes an honest error of judgment in a situation which there is a room for doubt.

9.2.2.6 Date and the Audit Report: Three dates are often given consideration in an audit report. These are:

The date to which the audited financial statements were prepared; in the above case 31st Dec., xxxx

The date of signing the report, in this case 31st January xxxx

The date of the AGM of the company

The date on the audit report should be appended after all other information contained in the financial statement have been approved by the board of directors, and the auditor has considered all availed evidence, including receipt and review of directors' report, the Chairman's Statement, etc.

The implication of the above is that audit reports are dated before the AGM, after which the auditor appears to have discharged his obligation under the contract between him and the shareholders.

For sensitive audits, especially the audit of public companies, for the auditor to carry out a special review of post balance sheet events in order to obtain assurance on the following:

- That all material post balance sheet events, if any have been identified.
- That all such events are adjusted for and disclosed in the financial statement either directly or by circularization, as appropriate in the circumstances.
- That a review of all known risk area has been undertaken.
- That a review of minutes of meetings of shareholders, directors and management committees does not reveal any matter which is inconsistent with the view expressed in the audit report.

That known external information from the media, development overseas, have adverse effect on the company's affairs which the auditor has reported upon.

9.3 Qualified Audit Reports

In all the above cases, we have been talking of unqualified. Otherwise referred to as 'clean reports', which in the layman's view represent a 'clean bill of health'.

There are however circumstances where the auditor is unable to issue such a clean bill because he is not satisfied with the quality of the accounting information he audited. In the circumstance, he should express his adverse opinion; or our auditing parlance, qualify his audit report.

9.3.1 Dissatisfaction of Auditor

In qualifying his report, the auditor must express his dissatisfaction fully as he sees it, leaving nothing in doubt. He should further state the reasons leading to the qualification, and quantify the effect on the financial statement where applicable. He will not be absolved from liabilities if he merely report his dissatisfaction to the directors of the company' without conveying such to the shareholders in his report.

The Circumstances which may lead the Auditor to Qualify his Report, inter alia, are:

- Failure to obtain all the information and explanations the auditor believes are necessary to his audit.
- Failure to keep accurate and dependable accounting books and records, thus denying the auditor an adequate basis for the measurement of the accounting information being attested
- Dissatisfaction of the auditor with the company's system of internal controls in relation to weaknesses which could largely allow fraud and effort to occur, thus leaving the auditor in uncertainty about the accuracy and dependability of the accounting data he was examining.
- Dissatisfaction of the auditor with the suspicious attitude or action of the management in relation to legitimate inquiries on which the auditor has been put on certain suspicious and sensitive matters.

In the above four cases, the qualification was caused by the uncertainty the company has created for the auditor in relation to reaching his opinion. There are some cases where although there is no element of uncertainty, the auditor merely disagrees with the directors on the issue of another, and on that basis qualifies his report.

9.3.1.1 Reasons for disagreement

Disagreement with the financial accounting concepts, bases and policies used by the company in the valuation and allocation of accounting data for the reasons that:

- They are not suitable to the business of the company.
- They have not been consistently applied. They are generally accepted by the accountancy profession.
- Disagreement with the disclosure of the accounting information in relation to the best accounting practice or the minimum disclosure requirements of the CAMA 1990, or those contained in other regulatory edicts.

9.3.2 Types of Qualification

Disclaimer:

The auditor may be faced with financial statements on which he is unable to form an opinion. In the circumstance, he should disclaim an opinion and give his reasons for so doing.

Such instances could be:

- Lack of co-operation by the management or staff
- Lack of adequate evidence on which to base his judgment.
- Inherent uncertainty in relation to loopholes in the company's system of controls.

Opinion, Subject to:

In some circumstances, the auditor may be able to form a positive opinion, subject to a doubt or uncertainty not on the validity of the accounts as a whole, but on a given aspect, e.g. where he failed to verify goods said to be in transit, and the related documents are said to be seized by customs officials, leaving the auditor with no other than the verbal evidence of the directors. The matter leading to this type of qualification is therefore usually not fundamental enough to cause a qualification of the entire financial statement.

Except Opinion:

The auditor may find much of the accounting data adequately measured and reported upon, but may disagree on certain items which are not considered fundamental, and which do not give a true and fair view on the entire accounts excepting those item or the item he disagrees with as not having a true and fair view. Examples are departure from SAS provisions, inappropriate accounting policy, extent and manner of disclosures, etc.

Outright Qualification:

Where the auditor is convinced beyond all reasonable doubts that the accounts do not give a true and fair view, he should quality his report in no mincing words, putting the case as he sees it, with his reasons for and quantification f the qualification.

9.4 Report Content

The audit report should be easily understood. The subject of audit should clearly identify the area, system or the proposal being audited, reviewed or having agreed upon procedures applied. Present the scope and the auditor's findings and conclusions objectively and completely, with appropriate support for positions taken, and provide recommendations for improvement, whenever appropriate.

a. Accuracy, Completeness, and Fairness.

Report preparation, review, and processing procedures should be applied to produce reports that contain no errors of fact, logic, or reasoning. The need for accuracy is based on the need to be fair and impartial in reporting and to assure readers that what is reported is reliable. One inaccuracy can cast doubt on the validity of an entire report and can divert attention from the substance of the report. Although reports should be concise, they should not be so concise that they do not fully inform the user. Reports should contain sufficient information about findings, conclusions, and recommendations to promote adequate understanding of the matters reported and to provide convincing, but fair, presentations in proper perspective. Sufficient amounts of background information should also be included. Readers should not be expected to possess all the facts that the auditor has.

Therefore, reports should not be written on the basis that the bare recitals of facts make the conclusions obvious or inescapable. If the auditor has conclusions or opinions that he or she wishes to present, the auditor should state them clearly and specifically. Presenting valid findings in their true light is essential to the accuracy and the integrity of the report. These findings must be presented so they can be clearly understood.

b. Objectivity.

Findings should be presented in an objective and unbiased manner and should include enough information on the subject matter to give readers proper perspective. Reports should be fair and not misleading and, at the same time, emphasize matters needing attention. The auditor should guard against any tendency to exaggerate or overemphasize deficient performance noted during the audit. The information needed to provide proper report balance and perspective should include:

- appropriate information as to why the examination was made;
- information about the size and nature of the activities or contract(s) to which findings relate;
- correct and fair descriptions of findings so as to avoid misinterpretation.

Where audit sampling or other quantitative methods are used, a comment to that effect should be made part of the auditor's explanation of the individual cost elements involved. The audit report must disclose whether the auditor used either a nonstatistical or statistical sample as a basis for the audit conclusions. The report must also include details concerning the sample universe, the sampling method, and sampling unit. The report will state whether the statistical sampling results were projected to the sampling universe. Audit reports with projections will also include the confidence level and confidence interval boundary amounts. If the results were not projected, the report should explain the reasons why the results could not be projected.

c. Adequate Support.

Sufficient objective evidence to demonstrate or provide the basis for each matter reported, with an assessment of its accuracy or reasonableness, should support all factual data, findings, and conclusions in reports. Except as necessary to make convincing presentations, detailed supporting data need not be included in reports. Opinions and conclusions in reports should be clearly identified as such and should be based on enough audit work to warrant them. In most cases, one example of a deficiency can support only a finding of a deviation, error, or weakness; it cannot support a broad conclusion and a related recommendation for corrective action. When appropriate, audit reports should refer to other audit reports pertaining to matters covered. For example, comments pertaining to the adequacy of the accounting system, purchasing practices, and indirect cost rates should be referenced to reports issued on these subjects.

d. Recommendations.

The auditor's report should contain appropriate recommendations whenever the audit discloses that the contractor's operations can be significantly improved. The auditor should also make recommendations to effect compliance with legal or regulatory requirements when significant instances of noncompliance are noted. If the auditor cannot make appropriate recommendations, the report should state why the auditor is unable to do so and what additional work needs to be done to formulate recommendations. However, the audit report is only advisory. Because recommendations are not directives, there is no contractual requirement for the contractor to comply. Therefore, reports must be worded in a manner that will induce confidence in, and acceptance of, the audit findings and recommendations. Tactful, tempered, and factual reporting can achieve the objective of acceptance without diminishing the auditor's independence. Conversely, sharp, critical, and inflammatory expressions should be avoided because they create resentment and an atmosphere in which the auditor's conclusions may be challenged. To ensure full and fair reporting, care and diligence should be exercised so that the audit report fully recognizes contractor difficulties, other pressing needs, and corrective action taken.

e. Issues Requiring Further Study.

If the scope of the audit or other factors limit the auditor's ability to inquire into certain matters which he or she believes should be studied, report such matters and the reasons why they merit further study.

f. Recognition of Noteworthy Accomplishments.

Information on satisfactory aspects, not just the deficient aspects, of operations examined, when significant and when warranted by the extent of the work, should be included in the auditor's report. Such information is often necessary to fairly present the situation that the auditor finds and to balance the report.

g. Views of Contractor Officials.

Except for audit findings in reports containing forecasted costs (refer to a listing of these reports at 10-206.2c.), one of the most effective ways of ensuring that reports are fair, complete, and objective is through advance reviews and comments by contractor officials. This produces a report that shows not only what was found and what the auditor thinks about it, but also what the contractor thinks about it and what, if anything, will be done about it. Comments on report drafts should be objectively considered and evaluated, and the report should appropriately recognize them. The auditor should drop a point or modify a position if he or she finds the contractor's argument meritorious. When a contractor promises corrective action, it should be noted in proper context but should not be accepted as justification for dropping a significant point or a related recommendation. However, if the advance comments oppose the auditor's findings or conclusions and are not, in his or her opinion, meritorious, the auditor should include the comments but should state the reasons for rejecting them.

h. Scope and Objectives.

The scope of the audit should be stated in all reports. Special considerations applicable to application of agreed-upon procedures reports are discussed below in 10-103.2j. Some audits are more limited in scope than others; for example, those confined to specific functions, activities, or contracts. Such limitations should be clearly and explicitly identified. When successive audits vary in scope, the auditor should explain why particular work was or was not performed and should also define the limited nature or special aspects considered in performing the audit. The time period of the audit should be specified. The report should also include a summary of the objectives of the audit. This statement is essential to give the reader a background against which any reported findings may be considered. The contracting officer may request special coverage; this, too, should be mentioned in the report. The auditor is expected to conduct the audit (or application of agreed-upon procedures) according to generally accepted government auditing standards incorporated in the guidance in this manual. The report will state that the audit was performed according to generally accepted government auditing standards and will discuss the requirements of those standards adapted to the type of audit being performed. The Scope paragraph will state that tests of appropriate records, internal controls, accounting principles and operations were made as necessary. The scope also includes a statement identifying the criteria used to evaluate the proposal or functional area. Scope of Audit statements vary for system audits and for cost accounting standards audits

i. Qualifications.

When acceptable auditing procedures cannot be followed, or have been limited by unavailable or inadequate records, time, or other reasons, and the limitations have a significant effect on the conduct, scope, or results of audit, the auditor should provide comments in the scope of the audit and qualify the report. When a report is qualified, the Scope of Audit paragraph always starts with the following qualifier, "Except for the qualifications discussed below,". The nature and impact of the qualification should be described briefly. A reference to the report section where details may be found should be provided.

j. Scope of Application of Agreed-Upon Procedures.

For application of agreed-upon procedures, the scope paragraph states that the engagement was limited to procedures specified by the requestor. The traditional scope paragraph, including control risk assessment, is omitted since an audit is not being performed. A qualifications section is not used since an audit opinion is not being given. However, a Restrictions on Procedures subsection, similar to the Qualifications subsection should be included when necessary to discuss items or circumstances that have prevented completion of all of the agreed-upon procedures.

k. Omitted Information.

If the auditor is prohibited from including some pertinent data in the report, he or she should describe what has been omitted and the restriction that makes the omission necessary.

9.5 Audit Opinion

a. Subject to specific reporting limitations, the report will express the auditor's opinion and recommendations, both on the cost representations or financial statements taken as a whole or, where appropriate, on individual elements. The report will also state whether the financial data have been prepared in accordance with the Federal Acquisition Regulation (FAR), the related agency supplement, if any, and Cost Accounting Standards (CAS), if applicable and/or any other criteria used.

b. Material changes in accounting policies and procedures and their effect on the financial data are to be explained in the audit report. In addition, the report will comment on significant financial issues affecting the contractor's cost representations. Violations of legal or other regulatory requirements, including instances of noncompliance, will be explained in the audit report.

c. The contract auditor's work normally culminates in an expression of opinion on the acceptability of the contractor's cost representations or financial statements. However, cost representations or financial statements often reflect estimates, approximations, and matters of judgment or opinion, rather than absolute facts. Although other acceptable alternative accounting methods exist within the concept of generally accepted accounting principles, the governing regulations in CAS and in FAR limit the contractor's flexibility in presenting cost representations.

d. A contractor's cost representations may be prepared in accordance with its accounting system, may be based on statistical computations developed as part of the regular accounting system, or from adjunct statistical data; or the contractor may use a formula method for developing costs. The audit report should contain the auditor's opinion as to the acceptability of the methods used by the contractor. An explanation of the methods used should be provided if it is not otherwise evident.

e. The auditor should determine if any material changes have been made in the contractor's accounting practices. Material changes and the reasons for them should be identified, and their effect on the financial representations, both historical and prospective, should be explained. The auditor should also state his or her opinion as to the propriety of the change. When applicable, CAS places some specific limitations on the extent of such changes and requires submission of price adjustment proposals as a result of changes made to previously disclosed or established cost accounting practices.

f. Events that occur after the audit may have a material effect on Government contract costs. Events, such as potential contract overruns, affect Government contracts directly, while other events, such as impending financial instability, affect all Government work. If such events occur before issuance of the audit report, they should be disclosed in the report. If an audit report has already been issued, but the impact on Government contract costs is significant, the auditor should issue a supplemental report.

g. The possibility that isolated errors of omission or commission will go undetected is always present. Therefore, the auditor cannot certify that all of the costs submitted by the contractor are correct. The auditor can only express a professional opinion as to the acceptability of the cost representations.

h. Before expressing an opinion, the auditor should have obtained and reviewed the available facts and performed, to the extent necessary, a searching and analytical review of the contractor's representations and supporting data. When necessary, the auditor should seek technical assistance from the contracting officer in those matters that fall within his or her purview, i.e., industrial engineering, production control, quality assurance, etc. The initial request should be oral, then confirmed in writing. The auditor should refer to and give effect to the technical findings and opinions of others in the audit report; when appropriate, attach a copy of the technical report to the audit report. If the auditor cannot get the necessary technical assistance before completing the audit, the opinion in the report should be qualified and should indicate the areas in which, and the extent to which, a technical evaluation is necessary. If the auditor disagrees with the technical evaluator's recommendations, he or she should attempt to reconcile the differences. If the differences remain unresolved, a copy of the technical report should be attached and an explanation provided in the audit report as to why the recommendations were not used.

i. When a contractor's cost representation or financial report is sufficiently complete to permit an audit evaluation, but does not conform to requirements imposed by contracts, agreements, laws, regulations, or administrative procedures (for example, format, timeliness, or certifications), or when certificates or information required from Government personnel have not been received, the audit report should explain the deficiency. The effect that the deficiency may have on the validity of the cost representation should be commented on when possible.

j. A contractor's reports and statements, both financial and operational, should contain the information necessary to form an opinion on contract financial management aspects. The responsibility for providing such information rests with the contractor. However, the auditor should comment if the data provided are insufficient to disclose any matters that may have a material effect upon Government contracts.

(1) Adequate disclosure does not imply or require that every available item of information be furnished. Disclosure should, however, be fair and reasonably complete, but not so complex as to confuse or impede understanding. Information should be reduced to manageable and understandable proportions; without summarizing to such an extent that needed background or relationships are omitted or blurred.

(2) Weight should be given to materiality, which is the relative importance or relevance of an item included in or omitted from financial reports or contract cost statements. Apart from

(a) the aggregate $10,000 materiality criterion for "Unallowable Costs Subject to Penalty" specified by FAR 42.709-5(b)

(b) the materiality of defective price findings , there are no universal ratios or percentages that can be used as standards of materiality for financial or operational processes or transactions. Materiality should be based on judgment. Six specific indicators of materiality that can be used individually or in combinations are:

- absolute dollar amount;
- ratio of amount of an item to an appropriate base figure;
- length of life of an asset;
- importance of the item to the accomplishment of the mission;
- importance to the maintenance of adequate controls
- characteristics of the items involved.

(3) The Cost Accounting Standards Board addressed the issue of materiality as it applies to CAS-covered contracts. No one criterion was considered necessarily determinative. The criteria are:

- absolute dollar amount;
- proportion of the amount under consideration to contract cost;
- relationship between a cost item and a cost objective;
- impact on Government funding;
- cumulative impact of individually immaterial items; and
- cost of administrative processing of the price adjustment modification.

(4) Events that occur after the audit may have a material effect on the operations of the contractor or on its financial representations. Such events should be disclosed in a supplemental audit report.

k. For application of agreed-upon procedures reports, always disclaim an opinion, since an audit is not being performed.

9.6 Planning the Audit Report

a. Planning to write the report begins with the receipt of a request for audit and/or establishment of the assignment. Planning continues throughout the audit process, from the development of the audit program to the completion of the working papers and then the report itself. The report will not be effective unless the needs of the customer are clearly understood and addressed. If there is any confusion regarding the request or the special needs of the requestor, call the requestor immediately for clarification.

b. Early in the audit process, determine what is required for the audit report. Ensure that the audit program is properly designed so all necessary information is obtained during the course of the audit. Working paper packages should contain lead working papers that are supported by sufficient detail to support the conclusions made. A detailed summary posted to each lead sheet should be used to draft the report. This will save time since the explanatory notes to the audit report are being written at the same time the audit is being performed. The copy and paste software function easily transfers the lead sheet summaries to the draft audit report.

c. Auditor and supervisory time will be saved in the report writing and review phases when interim supervisory reviews are performed. Interim reviews are beneficial since corrections and revisions may be made timely and supporting notes verified for use in the report. This will result in a properly documented working paper package, containing all of the evidence of a well-planned audit, and working paper notes which can effectively be incorporated into the report.

d. Writing an audit report requires original writing combined with CAM suggested wording. Use the suggested paragraphs and carefully revise them to describe the audit situation. “Shell” reports are incorporated in APPS and available on the DCAA Intranet for use as an aid.

Review Questions

1. What is an Auditor report?
2. What is the requirement of a Good Audit report?
3. What rules are to be followed for developing a good report?
4. Explain the features of an Audit report?

Discussion Questions

If you are an Auditor of an ABC company based at Punjab, what necessary content will you include while projecting your report?

Application Exercises

1. How to plan writing an Audit report?
2. Explain the various features engaged in Audit Opinion?

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