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SCHOOL OF MANAGEMENT STUDIES

UNIT I - PRACTICAL AUDITING – SBAA3001

Meaning and Definition of Auditing

The word Audit is derived from Latin word "Audire" which means 'to hear'. Auditing is the verification of financial position as disclosed by the financial statements. It is an examination of accounts to ascertain whether the financial statements give a true and fair view financial position and profit or loss of the business. Auditing is the intelligent and critical test of accuracy, adequacy and dependability of accounting data and accounting statements. Different authors have defined auditing differently, some of the definition are:

"Auditing is an examination of accounting records undertaken with a view to establishment whether they correctly and completely reflect the transactions to which they purport to relate."**- L.R.Dicksee**

"Auditing is concerned with the verification of accounting data determining the accuracy and reliability of accounting statements and reports." **- R.K. Mautz**

"Auditing is the systematic examination of financial statements, records and related operations to determine adherence to generally accepted accounting principles, management policies and stated requirement." **- R.E.Schlosser**

Objectives of Auditing

The objectives of auditing are changing with the advancement of business techniques. Earlier it was only to check the correctness of receipts and payments. The objectives of the auditing have been classified under two heads:

1) Main objective
2) Subsidiary objectives

Main Objective: The main objective of the auditing is to find reliability of financial position and profit and loss statements. The objective is to ensure that the accounts reveal a true and fair view of the business and its transactions. The objective is to verify and establish that at a given date balance sheet presents true and fair view of financial position of the business and the profit and loss account gives the true and fair view of profit or loss for the accounting period. It is to be established that accounting statements satisfy certain degree of reliability. Thus the main objective of auditing is to form an independent judgement and opinion about the reliability of accounts and truth and fairness of financial state of affairs and working results.

Subsidiary objectives: The subsidiary objectives of the auditing are:

1. Detection and prevention of fraud: the one of the important subsidiary objective of auditing is the detection and prevention of fraud. Fraud refers to intentional misrepresentation of financial information. Fraud may involve:
    a. Manipulation, falsification or alteration of records or documents
    b. Misappropriation of assets.
    c. Suppression of effect of transactions from records or documents.
    d. Recording of transactions without substance.
    e. Misapplication of accounting policies
2. Detection and prevention of errors: is another important objective of auditing. Auditing ensures that there is no mis-statement in the financial statements. Errors can be detected through checking and vouching thoroughly books of accounts, ledger accounts, vouchers and other relevant information.

Importance of Auditing

Importance of auditing can be judged from the fact that even those organizations which are not covered by companies Act get their financial statements audited. It has become a necessity for every commercial and even non- commercial organization. The importance of auditing can be summed in following points:

a. Audited accounts help a sole trader in knowing the value of the business for the purpose of sale.
b. Dispute over correctness of profits can be avoided.
c. Shareholders, who do not know about day-to-day administration of the company , can judge the performance of management from audited accounts.
d. It helps management in detecting and preventing errors and frauds.
e. Management gets advice on financial affairs from the auditors.
f. Long and short term creditors depend on audited financial statements while taking decision to grant credit to business houses.
g. Taxation authorities depend on audited statements in assessing the income tax, sales tax and wealth tax liability of the business.
h. Audited accounts are useful for the government while granting subsidies etc.
i. It can be used by insurance companies to settle the claims arising on account of loss by fire.
j. Audited accounts serve as a basis for calculating purchase consideration in case of amalgamation and absorption.
k. It safe guards the interests of the workers because audited accounts are useful for settling trade disputes for higher wages or bonus.

Comparison Table Between Accounting and Auditing

Parameter of Comparison	**Accounting**	**Auditing**
Definition	Accounting is the process by which day-to-day monetary records of the organizations are maintained and are further utilized to prepare the financial statements. These financial statements give a true picture of business health.	Auditing is the process of a comprehensive evaluation of the financial statements or records prepared under the accounting process. The main purpose is to verify the reliability of the financial statements.
Initiation	Accounting takes the input from the books of account or bookkeeping i.e. daily transactions that involve sale or purchase of something and then utilize them to prepare financial statements of the organization.	Auditing starts when accounting work is completed. The financial statements prepared by the accounts function are verified to check the accuracy, completeness, and trustworthiness.
Mode of Operation	Daily i.e. continuous process	Periodic i.e. quarterly or yearly
Scope	Current: The scope of work involves the creation of current year financial statements.	Past: The scope of work involves validating the past financial statements.
Objective	The main objective of Accounting is to assess whether a company has earned profits or suffered losses, thus establish the current financial position of the organizations for that particular period.	The main objective of Auditing is to verify the correctness of the organization's account and financial statements, thus certain or certify that they exhibit the true view.
Level of Detail	Very detailed as every financial transaction need to be captured	Sample-based
Key Deliverables	Financial statements e.g. Income Statement or statement of Profit & Loss, Balance Sheet, Cash Flow Statement, etc.	Audit Reports
Performed By	Carried by Bookkeepers and Accountants (internal employees of	Qualified Auditing agency or auditors (external & independent to the

Parameter of Comparison	Accounting	Auditing
	the organization)	organization)
Regulated or Governed By	Regulated by Accounting Standards that are issued by Accounting Boards of the specific country, and which need to adhere while preparing the financial statements.	Regulated by Auditing Standards that are issued by Auditing Boards of the specific country and also certain international compliance laws that need to adhere while auditing the financial statements.
Reports Submission	To the management of the organization	To management, the board of directors, and shareholders

Scope of Audit

The scope of an audit is the determination of the range of the activities and the period of records that are to be subjected to an audit examination.

Scope of an audit are;

1. Legal Requirements.
2. Entity Aspects.
3. Reliable Information.
4. Proper Communication.
5. Evaluation.
6. Test.
7. Comparison.
8. Judgments.

1. Legal Requirements

The auditor can determine the scope of an audit of financial statements following the requirements of legislation, regulations or relevant professional bodies.

The state can frame rules for determining the scope of audit work. In the same way, professional bodies can make rules to conduct the audit.

2. Entity Aspects

The audit should be organized to cover all aspects of the entity as far as they are relevant to the financial statements being audited.

A business entity has many areas of working. A small entity may have few functions while a large concern has many functions. The auditor has to go through all the functions of the business.

The audit report should cover all functions so that the reader may know about all the workings of a concern.

3.Reliable Information

The auditor should obtain reasonable assurance as to whether the information contained in the underlying accounting records and other source data is reliable and sufficient as the basis for the preparation of the financial statements.

The auditor can use various techniques to test the validity of data. All auditors while doing the audit work usually apply the compliance test and substance test. The auditor can show such information in the report.

4.Proper Communication

The auditor should decide whether the relevant information is properly communicated in the financial statements.

Accounting is an information system so facts and figures must be so presented that the reader can get information about the business entity. The auditor can mention this fact in his report.

The principles of accounting can be applied to decide about the disclosure of financial information in the statements.

5.Evaluation

The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by making a study and evaluation of accounting systems and internal controls to determine the nature, extent, and timing of other auditing procedures.

6.Test

The auditing assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by carrying out other tests, inquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.

There are compliance tests and substantive tests to examine the data. The vouching, verification and valuation technique is also used.

7.Comparison

The auditor determines whether the relevant information is properly communicated by comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarized the transactions and events recorded therein.

The auditor can compare the accounting records with financial statements to check that the same has been processed for preparing the final accounts of a business concern.

8. Judgments

The auditor determines whether the relevant information is properly communicated by considering the judgment that management has made in preparing the financial statements, accordingly.

The auditor assesses the selection and consistent application of accounting policies, how the information has been classified and the adequacy of disclosure.

MATERIALITY IN AUDITING

If an information given in the financial statements and other statements annexed thereof, influences the decision taken by the user, such information is said to be material information. The size and nature of the item determine its materiality.

An auditor has to apply his/her professional skill to assess whether an item is material or not. An auditor considers materiality in the following:

(i) In each class of transactions

(ii) In individual account balances; and

(iii) At the overall financial information presented.

Improper description of the accounting policy or non-compliance of legal and regulatory requirements or quantitative misstatements or qualitative misstatements may be considered as material if they influence the decision of the user. Errors or misstatements of small magnitude may cumulatively affect the truth and fairness of the financial statement.

What is material in one context will not be considered as material in another context. An item which would influence the decision of the user of the financial statements under one circumstance may not play a significant role in another circumstance. To determine about the materiality of an item, the auditor shall use his judgment.

INSTANCES OF MATERIALITY

1. The relative amount or quantity also determines the materiality.
2. If an item affects the profit and loss account significantly, it may be considered material.
3. While comparing the amount of a same item for two years, if the amount varies significantly, then the item may be considered material.
4. If, due to an insignificant mistake, a loss in converted as profit or vice versa, such mistakes will be considered material.
5. All items which are to be disclosed statutorily are considered to be material, even though the amount may be significantly small. For example, director‟s sitting fees, directors‟ remuneration etc.
6. If an item of small value affects the solvency in the balance sheet, such items may be considered as material.

DUTY OF THE AUDITOR AS TO MATERIALITY

Since materiality is judged by the auditor using his knowledge and experience and the materiality of an item varies with circumstances, determination of materiality always involves audit risk.

Therefore, auditors quantify audit risks and fix different materiality levels for different situations. When a misstatement exceeds this level, it is considered to be material by the auditor. The audit procedure is always designed to detect misstatement which exceeds the materiality level.

Ashok Arora and Kamal Gupta state that “the auditor is concerned with materiality while

*determining the nature, timing and extent of audit procedure;

*evaluating the effect of misstatements on the measurement and classification of account and

*determining the appropriateness of presentation of financial information.

The auditor should ensure that material items are not aggregated or set off against each other.

Types of audit

Based on ownership: On the basis of ownership audit can be:-

1. **Audit of Proprietorship:** In case of proprietary concerns, the owner himself takes the decision to get the accounts audited. Sole trader will decide about the scope of audit and appointment of auditor. The auditing work will depend upon the agreement of audit and the specific instructions given by the proprietor.
2. **Audit of Partnership:** To avoid any misunderstanding and doubt, partnership audits their accounts. Partnership deed on mutual agreement between the partners may provide for audit of financial statements. Auditor is appointed by the mutual consent of all the partners. Rights, duties and liabilities of auditor are defined in the mutual agreement and can be modified by the partners.
3. **Audit of Companies:** Under companies Act, audit of accounts of companies in India is compulsory. Chartered accountant who is professionally qualified is required for the audit of accounts of companies. Companies Act 1913 for the first time made it compulsory for joint stock companies to get their accounts audited from a qualified accountant. A number of amendments have been made in companies Act, 1956 and 2013 regarding appointment, duties, qualification, power and liabilities of a qualified auditor.
4. **Audit of Trusts:** The beneficiaries of the trusts may not have access and knowledge of accounts of the trust. The trustees are appointed to manage and look after the property and business of the trust. Accounts of the trust are maintained as per the conditions and terms of the trust deed. The income of the trust is distributed to the beneficiaries. There are more chances of frauds and mis-appropriation of incomes. In the trust deed as well as in the Public Trust Act which provide for compulsory audit of the accounts of the trust by a qualified auditor. The audited accounts of the trust ensure true and fair view of accounts of the trust.
5. **Audit of Accounts of Co-operative Societies:** Co-Operative societies are established under the Co-Operative Societies Act, 1912. It contains various provisions for the regulations and the working of these societies. Some of the states have adopted it without any change, while others have brought certain changes to it. The auditor of the Co-operative Society should have an expert knowledge of the particular act under which Co-operative society under audit is

functioning. He should also study by-laws of the society and make sure that the amendments made from time to time in the by-laws have been duly registered in the Registrar's Office. Companies Act is not applicable to the co-operative Societies. The Registrar of co-operative societies shall audit or cause to be audited by some person authorized by him, the accounts of the society once in every financial year.

6. **vi.Government Audit:** Audit of government offices and departments is covered under this heading. A separate department is maintained by government of India known as Accounts and Audit Department. This department is headed by the Comptroller and Auditor General of India. This department works only for the government offices and departments. This department cannot undertake audit of non-government concerns. Its working is strictly according to government rules and regulations.

Based on Time: On the basis of time the audit can be of following types:

i. **Interim Audit**: When an audit is conducted between two annual audits, such audit is known as Interim audit. It may involve complete checking of accounts for a part of the year. Sometimes it is conducted to enable the board of directors to declare an Interim dividend. It may also be for the purpose of dealing with interim figures of sales.
ii. **Continuous Audit:** The Continuous Audit is conducted throughout the year or at the regular short intervals of time.
"A continuous audit involves a detailed examination of all the transactions by the auditor attending at regular intervals say weekly, fortnightly or monthly, during the whole period of trading." - T.R. Batliboi
"A continuous audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or hiss staff attends at regular or irregular intervals during the period." -R.C Williams

Advantages of continuous Audit:

A. **Complete checking of all the records:** Since the audit is carried out throughout the year, sufficient time is available for detailed checking. Any enquiry and doubt arising in the course of audit can be tackled in a better way.
B. **Proper planning:** Auditor can plan his audit work in a systematic manner. He can evenly spread his work throughout the year. It will improve efficiency of auditor.
C. **Early detection of frauds and errors:** The work of auditor becomes easier for detecting frauds and errors, otherwise it will

involve more time.

D. **Up-to-date accounts:** The efficiency of account staff will increase and their work will be up-to-date and accurate.
E. **Valuable suggestions:** Continuous audit will help the auditor to understand the technicalities of business. This will help the auditor to make suggestions for the improvement of business.
F. **Preparation of interim accounts:** Interim accounts can be prepared without much delay. It will help the Board of Directors to declare interim dividend.

Disadvantages of Continuous Audit:

1. **Expensive:** It is an expensive system as it may not suit the budget of small organizations.
2. **Dislocation of routine work:** Frequent visits by auditor may dislocate the smooth flow of office work.
3. **Alteration of Figures:** after the accounts have been audited, the figures may be fraudulently altered by the staff.
4. **Losing link in the audit work:** As the work is not completed continuously, the auditor may lose continuity and certain questions and inquires may be left unanswered.

II. **Final Audit:** Final Audit means when the audit work is conducted after the close of financial year. A final audit is commonly understood to be an audit which is not commenced until after end of the financial period and is then carried on until completed.

III. **Balance Sheet Audit:** Balance Sheet Audit relates to the verification of various items of balance sheet such as assets, liabilities, reserves and surplus, provisions and profit and loss balance. The procedure under this audit is to follow a backward process. First the item is located in balance sheet, and then it is located in original record for the purpose of verification.

Based on Objectives: On the basis of objectives the audit can be of following types:

i. **Internal Audit:** It implies the audit of accounts by the staff of the business. Internal audit is an appraisal activity within an organization for the review of the accounting, financial and other operations as basis for protective and constructive service to the management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also properly deal with matters of operating nature.

ii. **Cost Audit:** Cost Audit is the verification of the correctness of cost accounts and adherence to the cost accounting plans. Cost Audit is the detailed checking of costing system, techniques and accounts to verifying correctness and to ensure adherence to the objectives of cost accounting.

iii. **Secretarial Audit:** Secretarial Audit is concerned with verification compliance by the company of various provisions o Companies Act and other relevant laws. Secretarial audit report includes

    1. Whether the books are maintained as per companies act, 2013.
    2. Whether necessary approvals as required from central Government, Company law board or other authorities were obtained.

iv. **Independent Audit:** Is conducted by the independent qualified auditor. The purpose of independent audit is to see whether financial statements give true and fair view of financial position and profits. Mainly it is for safeguarding the interest of owners, shareholders and other parties who do not have knowledge of day-to-day operations of organization.

v. **Tax Audit:** Now-a-days tax audit has become very important to ascertain the accuracyof tax related documents. Tax audit mostly covers income returns, invoices, debit and credit notes and various current and fixed assets. Tax audit is an innovation of 21st century. It has added one more chapter to the practice of auditing. Tax audit ensures the validity and credibility of tax related documents.

vi. **Efficiency Audit** is the **audit** which ensures that every rupee invested yields optimum results. The main objective of **Efficiency Audit** is to ensure that: (i) There is most optimum utilization of investment, and. (ii) That investment is canalized in most profitable lines.

vii. vii) Propriety Audit: Propriety audit has been described as an audit of the actions and decisions of the executives. The focus of such an audit is on the financial discipline, the authority structure, efficiency, rules and regulations and the protection of public interest.

Some of the important aspects of verification during a propriety audit are as follows

Financial records and accounts are accurate and up to the mark

The assets of the company are safeguarded and not misused

Propriety audit will check the utilization of funds

The results that are budgeted and expected are being met.

AUDIT TECHNIQUES

Techniques of audit are the methods or means adopted by an auditor for the collection and evaluation of audit evidences for his audit work. Important audit techniques are :

1)Vouching

2) Confirmation-It is the technique through which an auditor communicates with outside parties.

3) Enquiry-Enquiry is the technique of making enquiries with the responsible officials of the client and obtaining in depth information.

4) Reconciliation-It is the technique of identification and explanation of the items which cause the difference between two related items.

5) Physical examination-It is the technique of ascertaining the actual existence.

6) 6)Test checking

7) Analysis of financial statements

8) Scrutiny or scanning-It is the technique of making a quick and overall examination of books of accounts to verify whether the transactions are correctly and completely recorded in the books of account.

9) Extension verification-It is the technique of multiplying two or more amounts to verify whether the totals have been correctly arrived at.

10) Posting verification

11) Documentary examination

12) Observation-It is the technique by which an auditor observes or witnesses an act performed by others.

13) Footing-Footing is the technique of adding the columns of different accounting figures to test the accuracy of the total.

14) Flow charting-It is the technique of using flow chart to describe graphically the cause of the transactions through different stages from the beginning to the end.

Audit Programme

An audit program provides a basic plan for the audit team regarding the entity's business, its size, how to conduct the audit, allocation of work among team members and the estimation of time within which it should complete the work.

It contains details regarding the relevancy of evidence, materiality level, risk tolerance, measure of the sufficiency of the evidence. Thus, programs enhance the accountability of the audit team and its members for the work performed by them.

An audit program covers various steps of auditing in an audit program like the assessment of internal control, ascertaining accuracy and reliability of books of accounts, inspection, vouching and verification, valuation of assets and liabilities, scrutiny of accounts, presentation of financial statements, and submission of reports and related disclosures.

Advantages of the Audit Programme

1. An audit program helps in ensuring that all-important areas are considered while conducting the audit.
2. An audit program helps an auditor in the allocation of work among its team members according to their skills and competency.
3. It enhances the accountability of audit team members towards work performed by them
4. An audit program also reduces the scope for misunderstanding among team members regarding the performance of audit work.
5. It helps the auditor in checking the status of audit work, its progress, how much it is left for performance while conducting the audit.
6. Auditor prepares audit working papers which contains a record of various audit procedure applied which serves as evidence against the charge of negligence.
7. Audit program enables the auditor to keep a record of useful information specifically for future audit and references.

Audit Note Book: Meaning

Audit Note Book is a register maintained by the audit staff to record important points observed, errors, doubtful queries, explanations and clarifications to be received from the clients. It also contains definite information regarding the day-to-day work performed by the audit clerks. In short, audit note book is usually a bound note book in which a large variety of matters observed during the course of audit are recorded. The note book should be maintained clearly, completely and systematically. It serves as authentic evidence in support of work done to protect the auditor against any legal charge initiated against him for negligence. It is of immense help to the auditor in preparing audit report. It also acts as a valuable guide for conducting audit for future years.

Contents of Audit Note Book

The following matters should have been incorporated in an Audit Note Book.

1. A list of the account books normally used and maintained.

2. Names of the principal officers, their duties and responsibilities.

3. Nature of business carried on and important documents relating to the constitution of business like

Memorandum of Association, Articles of Association, Partnership deed etc.,

4. Extracts of minutes and contracts affecting the accounts.

5. Extracts of correspondence with statutory authorities.

6. Copy of audit programme.

7. Accounting methods, internal control and internal check system in operation.

8. Routine queries like missing receipts and vouchers etc.

9. Details of errors and frauds discovered during the course of audit.

10. Points to be included in audit report.

11. Details of all important information to be used as reference for future audits.

12. Date of commencement and completion of audit.

Advantages of Audit Note Book

1. Facilitates Audit Work: It facilitates the work of an auditor as all important details about the audit are recorded in the note book which the audit clerk cannot remember everything at all the time. It helps in remembering and recalling the important matters relating to the audit work.

2. Preparation of Audit Report: Audit note book helps in providing required data for preparing the audit report. An auditor examines the audit note book before preparing and finalizing the audit report.

3. Serves as Documentary Evidence: Audit note book serves as a documentary evidence in the court of law when a suit is filed against the auditor for his negligence.

4. Serves as a Guide: When a audit assistant is changed before the completion of audit work, audit note book serves as a guide in completion of balance work. It also acts as a guide for carrying on subsequent audits.

5. Evaluating Work of Audit Staff: It helps to assess the work performed by the audit staff and helps in evaluating their level of efficiency.

6.Fixation of Responsibility: Audit note book helps in fixing responsibility on concerned clerk who is responsible for any undetected errors and frauds in the course of audit.

7. **No Dislocation of Audit Work**: An audit note book contains all important details about audit hence any change in the audit staff will not disturb or dislocate the audit work.

Disadvantages of Audit Note Book

1. Fault-finding Attitude: It leads to development of a fault-finding attitude in the minds of the staff.

2. Misunderstanding: Very often maintenance of audit note book creates misunderstanding between the client's staff and the audit staff.

3. Improper Preparation: Since it serves as evidence in the court of law, it needs to be prepared with great caution. When the note book is prepared without due care it cannot be used as evidence against the auditor for negligence.

4. **Adverse Effects on Subsequent Audits**: Since audit note book is used in performing subsequent audits, any mistakes in the note book may have adverse impacts on the next audit.

Audit working papers

Audit working papers are used to document the information gathered during an audit. They provide evidence that sufficient information was obtained by an auditor to support his or her opinion regarding the underlying financial statements. Working papers also provide evidence that an audit was properly planned and supervised.

Objectives of audit working papers

1. The working papers serve the auditor both as useful audit tool as well as a permanent record of the audit work performed.

2. They are useful to the auditor to control the current year's audit work

3. They constitute a reliable guidance for planning the future audit assignments.

4. A review of the audit working papers gives an assurance that the audit work is both accurate and complete.

5. The auditors arrange the data properly in the working papers. Hence, the data become more meaningful and useful for the purpose of the,audit.

6. Working papers are necessary to corroborate the work and the findings of all the audit staff.

7. The chief auditor is assured that the opinion is supported by the findings of their audit staff.

8. The working papers constitute complete and conclusive evidence in future as to the entirety and completeness of the audit work.

Essentials of Good Working Papers

The essentials of good working papers are as follows:

1. Working papers should be complete in all respects. They should contain all necessary information so that they may be of maximum use.

2. They should be properly organized and arranged so that one may not experience any difficulty in locating a particular matter.

3. They must contain accurate information so that they will be relied upon.

4. They should contain the facts, which are of self-explanatory.

5. The facts given in working papers should be readily apparent to the reader.

6. The relevant details should always be kept in the working papers. All irrelevant information should be kept out of the space in order to enhance their utility for the purpose for which they are kept.

7. The audit working paper files should be properly preserved and filed. These files should be serially numbered and indexed so that they may be made available whenever they are needed.

8. Paper used for the preparation of working papers should be of better quality and uniform size.

9. Sufficient space should be left after each note so that any decision taken by an auditor may be written in that space.

1. Define Auditing.
2. Write down the essential features of auditing?

3. Explain the importance of auditing for the different stake holders?
4. What are the objectives ofanindependent audit?
5. What do you mean by propriety audit?
6. Difference between Government Audit and Commercial Audit.
7. What are the necessary steps to be taken by the auditor before commencement of the audit?
8. What are the procedures to be followed to detect errors?
9. What are the essential qualities required to act as an auditor?
10. What are the essentials will be there in the current file?

PART –B

1. Discuss in detail about the objectives and auditing?
2. Discuss the various kinds of auditing?
3. Distinguish between Auditing and Accounting
4. Distinction between Auditing and Investigation.
5. Explain the techniques adopted in auditing.
6. Explain the auditing and assurance standards issued by the ICAI in detail.
7. Explain the advantages and disadvantages of Audit?
8. Enumerate the audit programme in detail?
9. Discuss in detail about the audit working papers.
10. Enumerate the importance of Audit Note Book.

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SCHOOL OF MANAGEMENT STUDIES

UNIT II - PRACTICAL AUDITING – SBAA 3001

INTERNAL CONTROL - MEANING

Internal control is the whole system of control established by the management for the proper conduct of various activities of the organization. It is not only internal check and internal audit but also the whole system of control financially and otherwise established by the organization in order to carry out the business in orderly and efficient manner.

It is useful for the organization to safeguard the assets and serve the reliability of accounting records. In other words, it is the overall control adopted by the organization.

FEATURES

1) It is the overall control adopted by the management.
2) It comprises of plans, methods and procedures for the effective control of the operations of the business.
3) It comprises of internal check, internal audit, accounting system and administrative control.
4) It is established by the management.
5) It intended to help the management to run the business efficiently.

OBJECTIVES

1) To ensure that transactions are recorded proper books of account.
2) See that all transactions are carried out only on account of a sanction of authority.
3) See that management policies and decisions are properly implemented.
4) To ensure efficient conduct of business.
5) To evaluate the efficiency of performance of the various personnel.
6) To safeguard the assets of the organization.
7) To safeguard the interest of the organization.
8) To ensure reliability of accounting records.
9) To ensure the periodical verification of assets.

SCOPE OF INTERNAL CONTROL

Accounting control – it concerns with the prevention and detection of fraud and error, safeguarding of assets, accuracy and completeness of accounting records and timely preparation of reliable financial information.

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

Administrative control – It does not include all the administrative procedure and systems, but relates only to such procedure which relates to financial records such as budgetary control. The scope of this control is very wide. They also include accounting controls. Such controls comprise of the plan of organization that are concerned mainly with operational efficiencies. In short they may include anything from plan of organization 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.

ESSENTIALS OF GOOD INTERNAL CONTROL

1) It should be clear and well developed plan of organization.
2) There should be competent and trustworthy personnel for the success of the business.
3) There should be segregation of duties:-Operational duties are separated from recording duties. Physical handling of asset must be separated from accounting records.
4) There should be administrative traditions and practices for the performance of the duties.
5) There should be well developed and adequate accounting system.
6) There should be a sound system of maintenance and recording of accounts.

7) There should be effective internal check system.

8) There should be good audit system.

9) Periodical review of internal control.

ADVANTAGES OF INTERNAL CONTROL

A. Advantages to the business.

1) Provide accurate and reliable data to the management for taking correct decisions.
2) Ensure that policies and procedures are complied with.
3) Promotes operational efficiency.
4) Help to attain organizational goal.
5) To safeguard the assets of the organization.
6) To ensure the reliability of accounting records.

B. Advantages to the auditors

1) Helps the auditor in framing the audit program.
2) To ascertain extent of test check can apply.

LIMITATIONS OF INTERNAL CONTROL

1) Expensive.
2) Transactions of unusual nature may not be subject to internal control.
3) Human errors remain in any system of control.
4) Limitation of preventing frauds committed through collusion between persons.
5) It may not be keep pace with the change in the condition.

PRINCIPLES OF A GOOD INTERNAL CONTROL SYSTEM

An effective internal control system should have the following factors:

1. Competent and trust worthy staff: people in charge of internal control system must be reliable and highly competent about the work. Lack of knowledge and dishonesty will spoil the efficiency of the system.
2. Records of financial and other organizational plans: A good internal control system must have good documentation system. Filing, recording, classifying, etc will help in this regard.
3. Segregation of duties: normally, there should be a separate department for internal control

this reduces frauds, bias etc. normally; a clerk in charge of accounting function should not be in charge of assets also.

4. Supervision: proper reviewing of the operations of the company regularly makes the control system effective.
5. Authorization: all transactions must be properly authorized. In other words, the authority of each person should be well defined.
6. Sound practices: the company should have well established procedures, policies, delegations organizational manuals etc.
7. Internal Audit: it's a part of internal control and it should be independent of internal check.
8. Accounting Controls: proper accounting information systems should be established so that the information relating to accounts is properly collected, recorded and accounts prepared.

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 revised. No internal control system can be effective without such plan of organization.

ii. A scientific system of authorization 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 authorization and

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 organization smoothly.

iv. Since internal control system is to be exercised by the personnel employed in the organization, 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.

INTERNAL CHECK - MEANING

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 recognized by the auditor especially 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 cannot 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 organization before he had accepted it as correct.

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.
- the principle of division of labour.
- To have an accurate and reliable record of all business transactions.

ESSENTIAL 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.

ADVANTAGES OF INTERNAL CHECK

A. Advantages to business

1. Proper division of work
2. Fixation of responsibility
3. Greater efficiency of the staff.
4. Increased carrying capacity.
5. Early detection of errors and frauds.
6. Easy preparation of final account.
7. Truth and accuracy of accounting can be available.

B. Advantages to Owners.

1. Genuineness and accuracy of the account.
2. Overall efficiency, economy in operations, increased profit etc..

C. Advantages to Auditor

1. There is no need for detailed examination of book of accounts.
2. It reduces burden.

LIMITATIONS OF INTERNAL CHECK

1) Suitable only for big concerns.
2) Sacrifice of quality for quickness.
3) Certain type of disorder, confusions etc...in the working of the Organization.
4) Useful only when there is no collusion between employees.
5) Risky for the auditor.

PRINCIPLES AND ESSENTIAL OF GOOD INTERNAL CHECK SYSTEM.

1) Simple, easy workable and effective.
2) Not be too expensive.
3) Carefully devised and properly regulated.
4) Authority should be clearly defined.
5) Proper division of responsibility.

6) Division of work among the staff.

7) Work of similar nature should be entrusted with one person to ensure Specialization.

8) No individual should be allowed to perform one work completely.

9) Work should be distributed in such a way that the work of one staff is automatically checking another.

10) No employee should be allowed to remain a particular job for a long period.

11) No employee of the concern should be relying upon too much.

12) Proper reporting to the management.

13) Proper system of filing vouchers.

14) Safeguards should be prescribed for the safe custody of unused cheque book, securities etc…

15) There should be a self-balancing ledger system.

16) All incoming letter should be opened by responsible officers.

17) The receipt of cash and disbursement should be entrusted to different personnel.

18) Cashier should have no access to ledger.

19) All remittance received should be deposited in a bank immediately.

20) All cash payments should be made by a cheque.

21) Cash and bank balance should be verified frequently.

22) Petty cash payment should be on imprest system.

23) There should be effective control of receipts and issue of goods.

24) There should be a perpetual inventory system.

POINTS TO BE CONSIDERED IN FRAMING A GOOD INTERNAL CHECK

1. No single employee should have independent control over any important aspect of the business. In other words the work of employed should be automatically received by another.
2. The duties of the employees should be changed from time to time without prior notice.
3. Employees who control physical assets should not have assets to goods of account.
4. It’s better to follow a system of self-balancing ledger.
5. Account must be periodically verified.
6. The allocation of work must be carefully done and the position must be reviewed periodically.

7. While stock taking the pricing and evaluation of stock should be done by the people who are not connected to stores department.

INTERNAL CHECK AND THE AUDITOR

The auditor before starting audit work evaluates the system of internal check. If it is efficient he may avoid detailed checking of the transactions and he can carry out a few test check of the transactions to what extent should an auditor rely upon the system of internal check will depend upon the degree of effectiveness with which, the system is followed as well as the size of the business. If the internal check system is inefficient, he had to check in detail all transactions. It should be remembered that even if the internal check system is efficient he should still test its existence and efficiency.

Efficient internal check system reduces his work but not his responsibility. If in the process of examination of accounts if he finds any weakness in his system, he should report it to his client. Thus the existence of a good internal check system may help an auditor to a great extent, but does not reduce his legal liability. If any fraud is discovered subsequently he may be held quietly of negligence. He can’t defend himself saying that he relied upon the efficient internal check system that existed in the business.

INTERNAL CHECK REGARDING CASH SALES

Sales over the counter. The following is the internal check system regarding sales over the counter.

1. Each counter should have a separate salesman.
2. Each salesman should be given a separate sales memo book. Usually different color is used for different counters,
3. Sales memo should be prepared by the salesman in 4 copies.
4. The sales memo is checked by another clerk before being handed it over to customer. A copy is retained by the clerk.
5. Payment is made at the cash counter.
6. One copy of cash memo is returned to the internal duly stamped as cash paid 2 copies are returning the cashier.
7. The cashier records days total sales in cash sales register.
8. Every salesman should prepare total sales summary of the respective counters. At the end of the day total sales as recorded by salesman, total cash received and total sales as per register must agree with each other.

Postal Sales

A separate register should be maintained to record details of postal sales. Cash may be received either with order (cwo) or at the time of delivery (cod). Proper records will be made in this regard for cash received and due. Usually, goods are sent by VPP (value payable post). The sales register must be checked in detail by a senior officer.

Sales by Traveling Agents

1. Traveling salesman should not be allowed to issue final receipts to customers.
2. Amount received must be remitted to H.O. account on daily basis.
3. Salesman should not be allowed to deduct their expenses or commission from the sale proceeds.
4. The salesman should submit periodical sales report which must be examined in detail.

INTERNAL CHECK REGARDING WAGES

In a large organization, expenses on wages with form one of the major portions of expenses. The chances of frauds are also high in this regard. In this background, a good system of internal check assumes significance.

a. Frauds might be in the form of recording more wages than actually paid.
b. Payment of wages to dummy/ghost workers ecording wages for which no payment has been made etc.

The design of internal check system should try to prevent the above fraud. The following internal check system is suggested in this regard.

1. Maintaining Time Records:

A department is in charge of recording the time spent by the workers should be constituted as far as possible. Manual system of time keeping must be avoided. This brings down the fraud regarding the payment of wages for which no work is done.

The time keeping check and the foremen should separately prepare the time recorded sheet recording the name of the worker, time of entry, names of absentees etc.

In case if the workers are paid on piece rate system proper system of time booking must be followed each worker should be given a job and counter assigned by the supervisor.

In case if workers work overtime, the overtime slips must be issued this is authorized by the concerned official. No worker should be allowed to work Over Time if he is not authorized to do so.

2. Preparation of Wage Sheets:

Large scale organizations should evolve in an internal check system in such a manner that the chances of over payment, under payment, wrong payment to workers are minimized and prevented. Preparation of wage sheets should be the responsibility of a separate department. Separate wage sheets should be maintained for workers under time rate system and price rate system.

Two clerks should examine the time and price wage records. Over time records etc another clerk should be in charge of preparing wage sheets of individual works. The 4th clerk checks the calculations deduct amount for PF, IT, etc to arrive at net amount to be paid to workers. All officials involved in the process, should sign the statements which will be approved by the work manager/ the production manager.

3. Payment of Wages: a person is not involved either in maintaining time records preparation of wage sheets should be in charge of payment of wages. Usually the cashier in the accounts department will allot the wages, according to the information given by the wage sheet. As far as possible wages should be distributed personally to the workers who sign the Wage Register. Absentee workers should be paid through others workers only after written authorization is received. A list of unpaid wages should be prepared after the distribution of wages. If there are casual workers, payment should be made to them separately on a different day.

INTERNAL CHECK AS REGARDS PURCHASE.

The purchase department, will be responsible for proper control over purchases as far as possible. Purchases must be centralized for the purpose of internal check. The purchase process may be divided as:

1. Purchase.
2. Storage.
3. Issues of Materials.

1. Internal Check regarding Purchase of Materials: The concerned department, head will send requisition letter to the purchase department, for each department, a separate file must be maintained for requisitions. Based on the requisition the purchase committee, purchase department, calls for tenders from approved suppliers. These tenders must be opened by the purchase committee and the least bidder will be chosen.

Purchase order has to be sent to the selected suppliers. Usually, purchase order will be prepared by the purchase dept, a copy of which will be sent to the supplier, second to the stores, third to the accounting department, and the fourth is retained by the purchase dept.

When goods are received the stores keeper inspects them and compared with the purchase order. If goods are acceptable he enters them in goods inward book and issues the acceptance letter. A copy of the acceptance letter will go to the accounts department, which will again compare goods approved letter with the purchase order. The accounts manager if satisfied authorizes for its payment.

2. Internal Check over Storage of Goods: The stores keeper should maintain proper records, regarding storage of goods. He usually maintains bin cards and stores ledger surprise.
3. Internal Check as regards to issue of Materials: Materials should always be issued against material requisition note. After each issue, and purchase proper record must be made in bin cards and stores ledger.

INTERNAL CHECK IN A DEPARTMENT STORE:

A department store is a large scale retail organisation working on self-service basis selling the daily requirements of the customers. These are centrally located and attract customers.

Operation of Department Stores:

As the name itself suggests a dept., store is divided into many small departments, each department offering a specific product line. These depts., are headed by supervisors assisted by stock assistants. While the accounting departments, takes care of recording all transactions, in the cash department, will be in charge of receipts and payments of cash. As it operates on self-service basis cash is paid by the customer at the counter.

INTERNAL CHECK AS REGARDS PURCHASE.

Goods are to be purchased as per the order of the G.M. The General Manager prepares purchase order based on the requisition notes sent by the supervisor. No supervisor should be given independent charge of purchase. A copy of the purchase order is sent to the accounting department and stores dept., when once the goods are received the store keeper verifies them with the order and approves for payment. The accounts department makes the payments after verifying the Purchase order and goods.

INTERNAL CHECK REGARDING CASH RECEIPTS.

Usually the cash counters are computerized which brings down the human errors. The customers make the payments directly at the counter. The counter clerk prepares the bill and receives the cash. Chances of error and fraud are less as goods are coded and price is mentioned against codes.

As far as petty cash expenses are concerned, the cashier should be in charge of petty cash expenses, which are recorded on daily basis. The goods are delivered after verifying the bill.

INTERNAL AUDIT

MEANING

Large scale organizations usually develop a system to review their activities to identify areas of non-performances. Internal audit is a tool used in this regard.

DEFINITION

Internal auditing involves a continuous critical review of financial and operating activities by a staff of auditors functioning as full time salaried employees.

OBJECTIVE OF INTERNAL AUDIT

1. To comment of the effectiveness of the internal control system in force and means of improving it.
1. To verify correctness accuracy and authenticity of the records presented to management.
2. To facilitate early detection of errors and frauds.
3. To ensure that standard accounting practices are followed.
4. To ensure that assets are properly acquired, safeguarded and accounted for.
5. To investigate in the areas as requested by the management.
6. To see that exhibited liabilities are valid.

ADVANTAGES OF INTERNAL AUDIT

1. Internal Audit makes the system of internal control more effective and efficient.
2. It makes the auditor's work simpler.
3. Errors and Frauds are detected early.
4. It increases the morale of the employees.
5. Employees will be more careful as their work will be audited immediately.

DISADVANTAGES OF INTERNAL AUDIT:

1. Small organizations cannot afford to have internal audit system as it's expensive.
1. The regular work of the organization will be affected.
2. Internal auditor acts as a staff manager hence there are chances of differences of opinion between the internal auditor and the employees of the company.

NATURE OF INTERNAL AUDIT

The following are the nature of internal audit:

1. Independent: The internal auditor should work independently. The word independent implies that the audit work should be free from any sort of restrictions that may have a significant impact on the scope and effectiveness of the review process and on the reporting of the findings and conclusions. Therefore, the internal audit work is detached from regular day-to-day operations of the organization.
2. Appraisal: The word appraisal implies a critical evaluation and assessment of the existing controls and operations of the business enterprise. The internal auditor should appraise them on the basis of appropriate criteria.
3. Established: The management should organize an independent internal audit department and duties should be specifically assigned to the department.
4. Examine and Evaluate: The terms of examination and evaluation describe the two fold functional roles and responsibilities of the internal auditor. Firstly the internal auditor should make an examination and enquiry for fact finding. Secondly he should make a judgmental evaluation after thorough examination.
5. Activities of the Organization: Internal audit aims at conducting a systematic examination of records, procedures and operations of an organization. The internal auditor should carefully examine the controls established inside the organization. In this sense internal audit can be described as *Control Over Other Controls*. Controls are essential for every organization. In the absence of controls, it would be impossible for any organization to protect its assets, rely on the records and perform its functions successfully. The internal auditor examines the effectiveness of each control system and traces out the deficiencies in each system.
6. Service: Internal audit is a service to the whole organization. The internal auditor is an employee of the organization. His services can be availed at any time of emergency. His advice can be obtained on any matter or point significant from the business and strategic point of view. His services can also be effectively utilized by other employees from the top to bottom. Any employee can consult him in solving the day-to-day problems.
7. To the Organization: The primary concern of an internal auditor is the phase of business activity where he can render any service to the management not only top

management but all other managerial as well as operating staff. Therefore, the internal auditor should be an expert in all branches of business. In this respect, the internal auditor is superior to the financial auditor and even the cost auditor. His services are very useful to all the employees throughout the organization at all times. The terms '*To the Organization*' also signifies that internal audit is a total concept of service having a broad meaning and connotation.

SCOPE OR FUNCTIONS OF INTERNAL AUDITING

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

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

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

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

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

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

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

DIFFERENCE BETWEEN INTERNAL CONTROL, INTERNAL CHECK AND INTERNAL AUDIT

INTERNAL CONTROL	INTERNAL CHECK	INTERNAL AUDIT
It is the whole system of control established by management.	It is the arrangement of accounting work under which the work of one person comes under another.	Continuous review of records by staff appointed for the purpose.
Scope of internal control is very wide. It includes internal check and internal audit.	Scope of internal check is less.	Scope of internal audit is less that of internal control wider than internal check.
The objective is to safeguard the asset of enterprise.	Objective is to locate errors and frauds.	The object of internalaudit is to assure the management that the system of internal control and internal check in operation are in effective in design and operation

There is no separate staff.	There is no separate staff	. It is conducted by the staff specially appointed for the purpose called as internal auditor
Internal control is exercised when the work of employees in progress.	Internal check is exercised when the work of employee is in progress.	It is undertaken by the auditor after the work has been completed.
Any organization can adopt internal control	Any organization can adopt internal check.	Internal audit is adopted only those concerns which really need it

PROCEDURE OF AUDIT

Audit procedure refers to the way in which the audit work should be conducted. It is the procedure followed by an auditor for the actual conduct of his audit work.

There are certain aspects of audit procedure which are common in all audit works. They are:

1) Routine checking:-The checking of castings and postings of the common books of the organization is called routine checking. In other words it is the checking of subsidiarybooksandledgeraccountsbyanauditor.Routinecheckinginvolve the following operations,

a) Checking of the castings, sub castings; carry forward and other calculations in the books of original entry

b) Checking of the postings into the ledgers

c) Checking of the casting and balances in the ledgers

d) Checking of the transfer of the balances from the ledgers to the trial balance.

Generally, routine checking is conducted for the following books

a) Cash book

b) Petty cash book

c) Purchase book

d) Sales book

e) Purchase return book

f) Sales return book

g) Bills receivable book

h) Bills payable book

i) Journal proper

j) Sales ledger

k) Purchase ledger

l) Private ledger

m) Wages and salaries book

n) Stock sheet

Advantages of routine checking

1) It facilitates thorough checking of the books original entry
2) Under routine checking, postings are completely checked
3) It helps in verifying arithmetical accuracy of the entries in the books of accounts
4) Clerical errors and simple frauds are located by routine checking
5) Checking of posting and casting is helpful in preparation of trial balance
6) It is easy and simple job which can be done by any audit clerk

Disadvantages of routine checking

1) It can reveal only arithmetical errors and ordinary frauds
2) It is a mechanical checking, so it causes monotony
3) It is not important in the audit of a concern where self-balancing system is in operation

2). Test checking or sample checking or selective verification:-

Test checking means checking by an auditor, a few transactions selected at random here and there so as to form his final judgment on the whole set of transactions. It means to select and examine representative sample from a large number of similar items. Test checking involves sampling.

One objective of test checking is to arrive at characteristics presenting the mass transactions from the checking of representative sample.

Conditions or essentials or precautions of test checking:-

1) The success of test checking largely depends upon the system of internal check in operations the business.
2) The sample selected for test checking should be at random.
3) It should be applied only to homogeneous transactions.
4) The sample of test checking should be selected without bias.
5) One selection of sample should be made in such a way that it covers the work of each of the staff of the client.

Test checking should not be applied to cash book items.

No indication should be given to client as regards the method of test checking. One sample for test checking should be selected by the auditor himself.

There are certain transactions which are not suitable for test checking.
They is;

1) Opening and closing entries.
2) Cash book entries.
3) Transactions of seasonal industry.
4) Non-recurring transactions.
5) Bank reconciliation statement.
6) Items which are significant.
7) Transactions which are required by law is to be checked carefully.

Advantages:-

1) It helps the auditor to complete the audit work in a short time.
2) It helps in reducing the cost of audit.
3) It enables the auditor to undertake the audit of many concerns simultaneously.
4) It keeps the client staff alert and conscious.
5) If selection is done intelligently, test checking ensures the accuracy of books of account.
6) It ensures the periodic examination of the system of internal check.

Disadvantages:-

1) Test checking may fail to detect errors and frauds ,if selection is not done

intelligently.

2) Test checking increases the responsibility of the auditor.

3) Where there is test checking, the staff of the client may become careless.

4) Through test checking, an audit or may not get a true position of the financial state of affairs of an undertaking.

3) Surprise checks

Surprise checks constitute easy system under which an auditor makes a surprise checking of some of the important items. Surprise check, wholly cover;

a)Verification of cash.

b)Verification of investment.

b)Verification of records relating to stocks and stores.

d)Verification of books of original entry.

4) Audit in Depth

Audit in depth means the examination of the selected items in depth or in detail from the origin of the transactions to fair conclusions. In other words, it means step by step verification of selected items or transactions from the beginning to the end.

ADOPTION OF DISTINCTIVE TICKS, TICK, MARKS OR CHECK MARKS:-

In the cause of audit work, an auditor uses variety of marks or symbols to indicate the work that has been done. These marks or symbols are known as ticks or check marks or check signs.

Ticks are much significant to an auditor. They are useful to the auditor in the following respects;

a) Ticks help the auditor to know the checking that has been done by the earlier.

b) By means of ticks made earlier, an auditor can easily find out the alterations in the books account made subsequent to the audit.

c) Ticks facilitates tracing of processes and documents connected with the transactions and thereby increase the efficiency of audit.

POINTS TO BE NOTED OR PRECAUTIONS TO BE TAKEN WHILE USING TICKS:-

1) Different types of ticks should be used for different audit works.

2) Ticks should be small.

3) It should be clear.

4) It is advisable to use only pens or ball pens.

5) It is advisable to use ticks of different colours for different purposes.

6) Tick should not get mixed up with the figures shown in the books of account.

7) Ticks used by the client staff are not used by the audit staff.

8) Special ticks must be used for items which require special attention.

DIFFERENCE BETWEEN INTERNAL AND INDEPENDENT AUDIT

Internal	Independent.
1. An internal auditor is a regular employee of the company.	1. He is a professional auditor appointed by the company who is not an employee.
2. His duties, rights and responsibilities are determined by management.	2. The scope of audit work liabilities, duties etc are explained by concerned statutes.
3. He is appointed by the management.	3. He is appointed either by shareholders or by govt.,
4. It's not compulsory.	4. It is compulsory for all companies.
5. Internal auditor acts as an advisor to the management.	5. He is independent of the management.
6. To become an internal auditor professional qualification is not necessary.	6. An independent auditor must have professional qualification as per the act.
7. Internal Auditor ensures that the system of accounting is efficient.	7. the internal auditor comment on the true and fair view of business.
8. An internal auditor reports to the management.	8. The Internal Auditor reports to the shareholders.

9. Internal audit is a continuous process.	9. It’s a periodic process.

To conclude, it can be said that “the internal auditor’s responsibility is to the management and he is not a servant of the independent auditor. His scope will be decided by the management and eh should be free to communicate to the external auditor but should not involve himself with the work of independent auditor.

DIFFERENCE BETWEEN FINANCIAL VS.OPERATIONAL AUDITS

Financial audit is carried out with the intention of obtaining an independent opinion of ‘true and fair view’ on financial statements, while operational audit is carries out to check whether the operations of the organization are being carried out effectively and efficiently.

- In general, financial audit is carried out by external auditors, while operational audit is carried out by internal auditors.
- Financial audit report has a standard format, while operational audit report does not have a standard format.
- Financial audit reports must be published publicly, but operational audit reports need not to be made public.
- Professionals who are performing financial audit are external auditors that are not controlled by the management while auditors performing operational audit are employees of the entity and hence controlled by the management.

DIFFERENCE BETWEEN INTERNAL CHECKS AND INTERNAL AUDIT:

Internal Check	Internal Audit.
1. It is an arrangement of duties allocated in such a way that the work of one person is automatically checked by another.	1. It is independent appraisal of operation and records of the company.
2. The purpose of IC is to prevent minimize possibilities of errors and frauds.	2. The purpose is to detect errors and frauds that are already committed.
3.IC doesn’t require separate staff. It represents only the arrangement of duties.	3. It requires separate staff employed only for this purpose.

4. IC is a continuous process.	4. The Internal auditor has to report periodically about various inefficiencies and suggest improvements.
5. IC begins along with the recording of transactions.	5. It begins when the accounting process ends.
6. It is devices of doing the work.	6. It is a device for monitoring the work.
7. Scope of Internal Check is limited especially to the accounting department.	7. The scope of internal audit goes on beyond accounting department.

DIFFERENCE BETWEEN INTERNAL AUDIT AND STATUTORY AUDIT

An internal audit is conducted by the permanent staff of the same office to detect weakness in system, procedures and for the improvement. But statutory audit is the act of checking books of accounts as per the provision of company act. Both of them check books of account; detect errors and frauds even though they have certain differences which are as follows:

1. Appointment

An internal auditor is generally appointed by the management but statutory auditor is appointed by the shareholders or Annual General Meeting.

2. Legal Requirement

Internal audit is the need of management but it is not legal obligation but statutory audit is the legal requirement.

3. Qualification

An internal auditor does not required specific qualification as per the provision of law but qualification of statutory auditor is specified. Certificate issued by ICAI

4. Conducting Of Audit

Internal audit is of regular nature but final audit is conducted after the preparation of final account.

5. Status

An internal auditor is staffs who are appointed by the management but statutory auditor is an independent person appointed by the shareholders.

6. Scope of Work

Internal audit is related to the examination of books of accounts and other activities of an organization but statutory audit checks the books of accounts and related evidential documents. So, scope of internal audit is vague but scope of statutory audit is limited.

7. Removal

Internal auditor can be removed by the management but statutory auditor can be removed by the annual general meeting only.

8. Remuneration

Internal auditor is appointed by the management; so remuneration is fixed by the management but remuneration of statutory auditor is fixed by the shareholders.

9. Report

Internal auditor needs to give suggestions to improve weakness but no need to present report but statutory auditor requires to prepare report after the completion of work on the basis of facts found during the course of audit and present such report to the appointing authority.

AUDIT EVIDENCE

Audit evidence is evidence obtained during a financial audit and recorded in the audit working papers. In the audit engagement acceptance or reappointment stage, audit evidence is the information that the auditor is to consider for the appointment.

Audit evidence is evidence obtained during a financial audit and recorded in the audit working papers.

- In the audit engagement acceptance or reappointment stage, audit evidence is the information that the auditor is to consider for the appointment. For examples, change in the entity control environment, inherent risk and nature of the entity business, and scope of audit work.

- In the audit planning stage, audit evidence is the information that the auditor is to consider for the most effective and efficient audit approach. For examples, reliability of internal control procedures, and analytical review systems.

- In the control testing stage, audit evidence is the information that the auditor is to consider for the mix of audit test of control and audit substantive tests.

- In the substantive testing stage, audit evidence is the information that the auditor is to make sure the appropriation of financial statement assertions. For examples, existence, rights and obligations, occurrence, completeness, valuation, measurement, presentation and disclosure of a particular transaction or account balance.

- In the conclusion and opinion formulation stage, audit evidence is information that the auditor is to consider whether the financial statements as a whole presents with completeness, validity, accuracy and consistency with the auditor's understanding of the entity..

AUDIT EVIDENCE DECISIONS

A key decision the auditor must make is the appropriate types and amounts of evidence to draw conclusions regarding financial statements or internal control. You might suggest that all evidence available should be used--but unfortunately, the cost of sampling every piece of evidence in a population would be prohibitive. In practice, the profession of auditing often requires taking a sample, and then drawing a conclusion based on that sample.

There are four types of decisions that an auditor must make:

1. Which audit procedures should be used?
2. What sample size should be selected for the procedure?
3. Which items should be selected from the population?
4. When should the procedures be performed?

Each of these types of decisions is described briefly in your text, along with an example. Note how the example audit procedure is modified to include the sample size, specification of which items to choose, and the timing of the sample.

A collection of audit procedures (each including sample sizes, items to choose and timing) is called an audit program. An example of an audit program appears. As you might expect, a computerized version of an audit program can help the auditor organize the work.

WHAT MAKES THE EVIDENCE PERSUASIVE?

The evidence must be both competent and sufficient. Competence means that the evidence must be believable or worthy of trust. The seven characteristics of competent evidence include:

1. Relevance--to the audit objective that the auditor is testing;
2. Independence of the provider--information received from outside the entity is

presumed to be more reliable than from inside the entity.

3. Effectiveness of the client's internal controls--evidence from a client whose internal controls are effective is more trustworthy.
4. Auditor's direct knowledge--data or calculations prepared by someone inside the organization will not be as reliable as data computed or discovered by the auditor directly.
5. A qualification of the individuals providing the information--reliability of the information is enhanced if the person providing it is qualified to do so.
6. Degree of objectivity--objective evidence is more reliable than evidence that is subjective.
7. Timeliness--data that are timely for the purpose intended are considered more reliable.

TYPES OF AUDIT EVIDENCE

In deciding which procedures to use, the auditor may choose from seven different types of evidence:

1. Physical examination--of a tangible asset such as inventory, cash, or fixed assets. Your text points out that some items, such as checks, are assets only during that period when they have inherent value; prior to execution and after cashing, checks are classified as documents. Physical examination is a way to verify that an asset exists, or to verify its condition, but not to determine whether the client owns the asset.
2. Confirmation--is the receipt of a written or oral response from and independent third party verifying information requested by the auditor..
3. Documentation--consists of the client's business documents used to support accounting events. A strength of documentation is that it is prevalent and available at a low cost. Documents can be internal or externally generated. Internal documents provide less reliable evidence than external ones, particularly if the client's internal control is suspect. Documents that are external and have been prepared by qualified individuals such as

attorneys or insurance brokers provide additional reliability. The use of documentation in support of a client's transactions is called vouching.

4. Analytical procedures--are comparisons of account balances and relationships as a check on reasonableness. Analytical procedures are required during the planning and completion phases of all audits and may be used for the following purposes: 1) to better understand the client's industry and business; 2) assess the client's ability to continue as a going concern; 3) to indicate the possibility of misstatements ("unusual fluctuations") in the client's financial statements; 4) to reduce the need for detailed audit tests
5. Inquiries of the client directly from the auditor.
6. Re performance (rechecking) of samples of computations or information made by the client.
7. Observation by the auditor during the course of the audit.

METHODS OF OBTAINING AUDIT EVIDENCE

Inspection:

- The examining of records and documents or inspection of tangible assets
- Reliability of these records and documents depend on the nature and effectiveness of internal control
- Four major type of documentary evidence which provide different degree of reliability to the auditor are:
- Documentary evidence origination from and held by third parties
- Documentary evidence origination from third parties and held by the entity
- Documentary evidence origination from the entity and held by third parties and
- Documentary evidence origination from and held by the entity
- Note that inspection of tangible assets only ensures the existence of such assets but not their ownership or value

Observation:

- Looking at a process of procedure being performed by others
- Example like auditors' presence at clients' physical stock count

AUDIT SAMPLING

MEANING

In large organisations, the transactions will be enormous and repetitive in nature. (e.g.:- cash sales in the case of hotels, payments of wages in the case of construction company etc.) In such cases if the auditor verifies each and every transactions.

(i) Audit may not be completed within the required time.

(ii) Cost of conducting the audit will be very high

(iii) The auditor may lose the overall perspective and superficially check all the transactions.

To avoid the above, the auditor may select some transactions and verify them in depth. By examining the sample of representative transaction, the auditor arrives at a conclusion about all the transactions, this is called Audit sampling.

DEFINITION

"The application of an audit procedure to less than 100% of the items within a class of transactions or an account balance to enable the auditors to form certain conclusions about that class or balance as a whole".

Audit sampling can be conducted by test checking or by statistical sampling depending upon the size and nature of transactions.

Test checking – The auditor considers the size of the organization, the effectiveness of internal control, reliability of books and records and decides the size of the sample. The auditor with his experience selects the areas for test checking.

For example he may decide to check only the transactions of the first two months and last two months or he may select only 10% of certain class of transactions and say 20% of certain other class of transactions.

The auditor uses his judgment to select the transactions. This method is called judgmental sampling. This test check may be used to check the arithmetical accuracy of the transaction, to obtain confirmation from debtors and to test the compliance procedure.

Statistical sampling – Statistical sampling uses the mathematical laws of probability in determining the sample size under different circumstances. This method is applied in the areas where a large number of transactions of similar nature are present.

Example: Vouching of petty cash, pay roll checking etc.

In statistical sampling, specified numbers of transactions or balances are selected scientifically from the class of similar transactions/balances and the selected transactions/ balance are verified to draw inferences about the class as a whole.

PART –A

1. Define Internal Check.
2. Define Internal Control.
3. Define Internal Audit.
4. What is Operational Audit?
5. State the circumstances in which the errors and frauds are likely to occur.
6. What are the advantages of Internal Check?
7. What are the objectives of internal control?
8. Discuss about the scope of internal control?
9. What are the limitations of Internal Control?
10. What are the main functions of an Internal Audit?

PART –B

1. Compare Internal Audit with Independent financial Audit.
2. Discuss about the interface between Internal Audit and Statutory Audit.
3. Write down the principles and precaution of internal control system.
4. Difference between Internal Audit, Internal control and internal check.
5. Enumerate the audit procedure.

6. Differentiate financial Audit with operational audit.
7. Explain the adoption of tick, tick marks or check marks?
8. Elucidate the Internal check system that existed in the business?
9. Discuss various methods of obtaining audit evidence.
10. Discuss in detail about sampling in audit.

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SCHOOL OF MANAGEMENT STUDIES

UNIT III - PRACTICAL AUDITING – SBAA3001

VOUCHING

Vouching is the act of checking or examining the entries made in the books of account with the supporting the documentary evidences or vouchers.

In the words of .L.R DICKSEE,"Vouching is an act of comparing entries in the books of account with the documentary evidence in support thereof".

OBJECTIVES OF VOUCHING

1) The principal objective of vouching is to ensure that the transactions, as recorded in the books of accounts, are acceptable, genuine, properly authorised and correctly recorded.
2) Another objective of vouching is to ensure that all the entries made in the books are supported by necessary documentary evidence.
3) To see that all the transactions connected with the business have been recorded in the appropriate books of account.
4) To ensure that no transactions, which is not connected with the business, has been recorded in the books of accounts.
5) Detection of errors and frauds.

IMPORTANCE OF VOUCHING

Vouching constitutes the foundation upon which the super structure of auditing is erected. It is the backbone of auditing. In the words of F.R.M De Paula, vouching is the essence of audit.

Vouching can be regarded as the essence or back bone of auditing for the following reasons.

a) The success of an audit largely depends upon the care and attention with which vouching is accomplished.
b) Vouching is the most potent tool in the hands of an audit or to ascertain the accuracy of the transactions recorded in the books of account.
c) To see that all the transactions connected with the business have been recorded in the appropriate books of account.

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d) To ensure that there are no transactions, which are not connected with the business, has been recorded in the books of accounts.
e) Detection of errors and frauds
f) Vouching ensures the arithmetical accuracy of the books of account.
g) If vouching is done with care and caution, the auditor can smoothly proceed further in his work.

VOUCHERS

A voucher is the documentary evidence in support of a transaction recorded in the books of account. It is a documentary evidence of an entry in a book of account. The following are the some of the examples of vouchers:

a) Receipt obtained from a payee.
b) Counter foil of a receipt.
c) Purchase invoice.
d) Sales invoice.
e) Cash memo.
f) Bank pay-in-slip.
g) A contract or an agreement.
h) A resolution passed at the meeting of the board of directors.
i) Minutes of a meeting.
j) Bought notes.
k) Sold notes.
l) Debt note.
m) Credit note.
n) Wages sheet.
o) Salary register
p) Goods inward book.
q) Goods outward book.

TYPES OF VOUCHERS

1) Primary vouchers:- a primary voucher is written evident in original. Purchase invoice, cash memos for goods purchased etc. are examples.
2) Collateral or secondary vouchers:- even evidences in original are not available, copies of the evidences are produced in support. Again, sometimes, subsidiary evidences are also provided for the purpose of audit. Such vouchers are usually known as collateral or secondary vouchers.

ESSENTIALS OF VOUCHERS OR POINTS TO BE NOTED BY THE AUDITOR WHILE VOUCHING THE VOUCHERS

1) Vouchers are consecutively numbered, arranged serially in the order of the entries and are properly filed.
2) Vouchers are in the name of the client.
3) See the teach voucher is genuine on its face.
4) Voucher is certified as correct by a responsible official.
5) The amount of each voucher is written in words and figures.
6) Every voucher, which is a receipt for cash payment over Rs5000, bears a revenue stamp of Rs 1.
7) Alteration made in a voucher is properly signed by the maker and approved by a responsible official.
8) Any explanation is desired with to any voucher, the same should be noted n the audit note book.
9) Missing vouchers produced, the auditor should do,

a) Prepare a list of all such missing vouchers

b) Call for explanation from the concerned official from the l o s s of original vouchers compare with the entries in the cash book.

10) If any voucher requires a special scrutiny, the auditor should proceed cautiously and use special ticks for checking.
11) As far as possible the auditor should complete the vouching work relating to a particular period in continuous sitting.
12) The auditor should not take the help of any staff while vouching the vouchers.
13) Test checking may be resorted only in exceptional circumstances.

VOUCHING OF CASH BOOK OR CASH TRANSACTIONS

Cash transactions take place almost every day in business. An auditor should give care and attention to the vouching of cash transactions.

The main objectives of vouching of cash transactions are,

1) To ensure that all receipts of cash are duly accounted for.
2) To ensure that no improper payments are made.
3) To see that all receipts and payments of cash are actually and properly recorded.
4) To see that all payments have been made to proper persons and the payments are true payments.
5) To see that cash and bank balance correct and really exist.

Vouching of cash book or cash transaction covers the vouching of receipt side and vouching of payment side.

VOUCHING OF RECEIPT SIDE OR DEBIT SIDE OF CASHBOOK OR CASH RECEIPT TRANSACTIONS

Vouching of cash receipt transactions is more difficult than that of cash payment transactions, since there is greater chance of manipulation in regard to cash receipt.

The auditor should bear in mind the following points, while vouching the cash receipt transactions.

1) The auditor should carefully examine the system of internal check in operation with regard to cash receipt transactions.
2) An auditor can resort to test checking only if he has satisfied himself that there is an efficient system of internal check.
3) He should ascertain whether a diary of cash receipt or rough cash book has been in use. If a rough cash book has been in use, he should examine the entries in the rough cash book and
4) He should examine the methods of depositing daily receipts into the bank.
5) He should check the bank pass book with the entries in the cash book.
6) He should vouch cash receipts by reference to documentary evidences.
7) He should enquire into the system of allowing documents, the rate of discount allowed etc.
8) He should enquire into the bad debts written off. He should satisfy himself the bad debt written off is authorized by a responsible person.
9) He should ensure whether there is a proper control over use of receipt book. In this context, he should keep in mind the following points:

a) All receipts are on printed forms.
b) See that receipt book should be consecutively numbered.
c) The receipts have to be signed by a responsible officer.
d) The unused receipt book should be kept in safe custody.
e) All spoilt receipts should remain attached to the counter foils.

VOUCHING OF THE IMPORTANT ITEMS ON THE DEBIT SIDE OF THE CASH BOOK OR CASH RECEIPT TRANSACTIONS

*1)*__**Opening balance**__:-

The opening balance of the cash book should be vouched by comparing it with the closing balance of cash book as shown in the audited copy of the balance sheet of the previous year,

2) **Cash sales:-**

The vouching procedure in regard to cash sales should be on the following lines:

1. He should examine the system of internal check in operation in regard to cash sales.
2. After ascertaining the efficiency of the internal check system as regards cash sales, auditor should vouch the cash sales as follows:

a) Cash memos written by the salesman should be checked with the summery sales prepared at the end of the day.

b) He should examine the rough cash book, if any.

c) He should check up the rough cash book with the main cash book.

d) The summaries of daily sales should be checked with the entries in the stock register.

e) He should verify the daily deposit of cash received into the bank; pay-in- slip also should be vouched.

3) **Receipts from debtors:-**

While vouching the receipts from debtors, an auditor should bear in mind the following points:

1. He should enquire into the system of internal check in operation in regard to the receipt from debtors.
2. After satisfying himself about the efficiency of internal check in operation in regard to the receipt from the debtors, the auditor should conduct the vouching of receipts on the debtors on the following lines:

a) He should check the total cash received from the debtors by verifying the rough cash book with the counter foils of the receipts issued to customers.

b) He should check the cash book with the rough cash book.

c) He should check the details of cash and cheques paid into the bank.

d) He should enquire into whether bad debts are written off by a competent authority.

e) He should verify the balances due as per the schedule of debtors with letters of confirmation received.

f) He should be alert to the possibility of teeming and lading.

4). **Receipts from bills receivable:-**

Bills receivable include bills of exchange, promissory notes, and I.O.U's received from debtors. The receipts from bills receivable can be in two ways:

1). Receipts from bills discounted

The vouching of receipts from bills discounted should be as follows:

a) The amount of cash received from bills discounted should be checked by comparing the bills discounted book with the cashbook, passbook, B/R book.

b) See that proper records have been made in the books for discount on bills discounted.

c) He should determine the contingent liability in respect of bills discounted but not matured on the date of the balance sheet.

2). Receipts from bills matured

a) The auditor should check the cash received from bills matured by comparing the bills receivable book with the cash book and the pass book.

b) Special attention should be given to bills which have matured but remain unpaid.

***5).* Receipts from sale of investment**

Vouching of receipts from the sale of investment should be on the following lines:

a) Investments are usually sold through brokers, as such, broker's sold notes or contract notes should be examined to vouch the amount from the sale of investments. If the sale of investment has been effected through the bank, then, the bank advice should be examines to vouch the amount received from the sale of investments.

b) The sale proceeds of the investments should also be checked with the related investment account with the stock market quotations.

c) If the investment has been sold cum-dividend, the auditor should see that the sale proceeds are properly apportioned between capital and revenue receipt.

d) If the investment has been sold ex dividend, the auditor should see that the dividend is received and recorded.

e) He should see that the profit or loss on the sale of investment is properly adjusted.

f) If the investments are pertaining to some earmarked funds, the auditor should see that the profit or loss on the sale is transferred to the ear marked fund a/c.

***6).* Receipt from the sale of fixed assets**

Vouching of receipts from the sale of fixed assets should be on the following lines:

a) The auditor should see that the sale of fixed asset is properly sanctioned.

b) If the sale of fixed assets is through a broker, the proceeds of the fixed assets sold should be vouched with the help of sold notes. In the case of sale of fixed assets is through an auctioneer, the sale proceeds should be vouched with the help of the auctioneer's note. He can verify the cash receipt in the cashbook with the counterfoil or carbon copy of the receipt issued to the party. He may also vouch the sale proceeds of fixed assets with the correspondence with the parties and the sale contracts and the fixed asset a/c.

c) He should see that proper fixed asset a/c has been credited with the sale proceeds.
d) If there is any profit, the auditor should see that it is credited to capital reserve.
e) In the case of certain prepaid expenses in respect of fixed assets, the auditor should check whether suitable adjustments are made in the expenses accounts.

7). Loan received

Vouching of loan received should be on the following lines:

a) He should ascertain that whether client is empowered to borrow money.
b) In the case of a joint stock company, he should verify whether the legal provisions have been complied with.
c) He should verify the loan agreement to ascertain the terms and conditions on which the loan has been received.
d) If the loan is secured, he should ascertain what security has been offered and the value of security offered.
e) He should ensure that the loan amount received is recorded in the books of account.

a. If the interest on loan is unpaid, the auditor should see that it is properly adjusted.
b. Dividend on investment

f) The auditor should verify the dividend received is recorded in the cash book with the counter foils of the dividend warrants.
g) To see that dividends have been received in the dates.
h) If the dividend is sold ex-dividend, see that dividends are subsequently received are entered in the cash book and credited to dividend account.

8). Subscription received

9). Insurance claim received

10). Commission received

11). Rent received

12). Royalty received

VOUCHING OF CASH PAYMENTS OR CREDIT SIDE OF THE CASH BOOK.

While vouching cash payments, an auditor should pay attention to the following points.

1) All vouchers relating to cash payments should be serially numbered and properly arranged.
2) He should insist that the vouchers are properly dated.
3) He should evaluate the system of internal check in operation with regard to cash

payments and satisfy himself as to the efficiency of the internal check.

4) He should see that:

a) The cash payments are for the purpose of the business.

b) Payments are related to the period under audit.

c) The payments is properly sanctioned or authorized.

d) The payments are made to the right person.

e) The payments are supported by proper vouchers.

f) The payments are properly recorded in the cash book.

5) Examine the rough cash book items and compare it with the main cash book.

6) See that the payments made are posted to the concerned accounts.

7) See that the amount appears in the vouchers both in words and figures and it agrees with the amount in the cash book.

VOUCHING OF DIFFERENT ITEMS ON THE PAYMENT SIDE OR CREDIT SIDE OF THE CASH BOOK

1) Opening credit balance

The opening credit balance in the bank column can be verified from the previous year's audited balance sheet.

2) Cash purchases

The vouching of the cash purchases should be on the following lines.

1) The auditor should examine entries in the cash book with the help of cash memos or invoices issued by the supplier and also goods inward book.

2) Special attention should be paid to trade discount, which should be deducted from purchase.

3) See that the cash paid for the goods have actually received.

4) He should see that the purchases are duly authorized.

5) He should see that the amount paid is debited to the appropriate account.

6) To ascertain whether payment made for cash purchases relates to the business.

3). Payments to creditors

Vouching of payment to creditors should be on the following lines.

1) Payments to creditors may be vouched with the receipts issued by the creditors.

2) He should check the amount due to the creditors with the accounts of the creditors.

3) Examine the goods inward book and see that goods have actually been received.

4) The auditor should verify the periodical statement of accounts.

5) In the case of purchase made before the close of the year, see that goods not actually

received are kept out of the closing stock of the year.

4). **Payment of bills payable**

Payment of bills payable on their maturity should be vouched on the following lines.

1) The payment of bills payable, as recorded in the cash book, should be vouched with the bills payable book and also with the bills payable returned by the payees.
2) If the bills payable are through the bank, the auditor should examine the bank pass book for the payment.
3) He should see that bills payable paid and returned by the payees are cancelled.

5). **Vouching of loans advanced**

Loans advanced should be vouched by the auditor on the following lines.

1) He should see that loans advanced are properly authorised.
2) He should examine the loan agreement.
3) He should vouch the loan advanced as recorded in the cashbook with the loan agreement also with the receipt given by the borrower.
4) If the loan is advanced against any security, the auditor should examine the security and its title deeds.
5) Examine the mortgage deed, if the loan is advanced against mortgage.
6) See that the provisions of the companies Act as regards the granting of loans to directors and officers of the company are complied with.

6). Purchase of investment

Vouching of purchase of investment should be on the following lines.

1) The auditor should see that the purchase of investment is properly authorised.
2) If the investments are purchased through a broker, he should vouch the investments purchased with the broker's note.
3) If the investments are purchased through the bank, he should examine the bank pass book to check the payment.
4) He should make a physical verification of the investment purchased.
5) If the investments are purchased cum interest, he should see that the payment made is properly allocated between capital and revenue.
6) See that investments purchased are registered in the name of the client.
7) In the case of a company, the auditor should see that investments have been purchased in accordance with the provisions of the companies Act.

7). Payment of capital expenditure

The payment of capital expenditure refers to the payment made for the acquisition of the fixed assets such as land & building, plant & machinery, patent, copy right, furniture etc.

Vouching of payment of capital expenditure should be on the following lines.

1) The auditor should see that the payment of capital expenditure is properly authorised.
2) He should examine the document pertaining to the purchase and ownership of the fixed assets.
3) He should examine the invoices and the receipts obtained from the suppliers to ensure that payments have been made.
4) He should see that all expenses incurred for the acquisition are capitalised.
5) He should see that repairs and maintenance expenses incurred are charged to revenue account.
6) He should physically examine the fixed assets purchased.
7) He should vouch the cash boom entries for the payment of capital expenditure with the concerned ledger account.
8) See that property purchased is registered in the name of the client.

VOUCHING OF PAYMENT MADE FOR THE ACQUISITION OF PATENTS

Vouching of payments made for the acquisition of patents should be on the following lines.

1) If the patent has been purchased, the auditor should vouch the payment made for the patent with the help of the contract for sale and the receipts for the payment obtained from the seller.
2) If the patent has been purchased through an agent, the auditor should vouch the agent commission with the help of agents account and receipt given by the agent. He should see that the agent's commission is capitalized.
3) He should see that expenses incurred on the purchase of the patent are capitalized.
4) Where the patent is acquired through research, the auditor should see that all the expenses incurred on the experiments and the research connected with patents is capitalized.
5) He should see that payments made towards the renewal fee are charged to revenue account.
6) He should actually see the patent.

VOUCHING OF WAGES

The object of vouching wages is to ensure that the payment for wages as recorded in wage sheet and cash book, were actually made properly authorised and were correctly maintained.

Vouching of payment of wages should be done in the following lines.

1) He should enquire into the system of internal check in force in regard to the maintenance of wage records, preparation of wage sheet and payment of wages.
2) If the internal check is effective, the auditor can conduct the vouching of wages on the following lines.
a) He should check a few items of wage sheets here and there to ensure that the calculations are correct.
b) He should check totals of wage sheet with the cash book.
c) He should see that the amount of cheque drawn for wages tallies with the totals of wage sheet.
d) He should see that deduction from wages have properly adjusted and recorded in the books.
e) He should see that wages recorded in the cash book have actually been paid.
f) He should examine the system of employment of casual labour and check the payment made to casual labour.
g) He should see that proper record is maintained for unpaid wages.
h) Wages for the current months should be compared with the wages of the previous month. If there is a material difference, the auditor should enquire into the reason for the difference.

i) VOUCHING OF SALARIES

Vouching of payment made for salary should be on the following lines.
1) An auditor should enquire into the system of internal check in operation in the concern in regard to the payment of salaries.
2) If the internal check system in regard to the payment of salaries is sound, an auditor can conduct the vouching of salaries on the following lines.
a) He should see that the salary bill is prepared with the sanction of a responsible officer.
b) He should see that the salary register is duly signed by each employee and counter signed by a responsible official.
c) He should check the salary register with the entries in the cash book.
d) He should see that the deduction for provident fund, life insurance premium, income tax etc have been correctly made and properly recorded in the books.
e) For vouching salaries of the secretary, manager and other important officials, the auditor should examine the board's minute's book.
f) He should check the attendance register.
g) He should compare the salary bill for the current month with the salary bill of the previous month. If there is any material difference, enquire into the reason for the difference.

h) He should see that the total of the salary book for a particular month agrees with the cheque drawn for salaries.

VOUCHING OF PETTYCASHBOOK

Vouching of petty cash book should be on the following lines.

1) He should examine the system of internal check in force in the business in regard to the petty cash transactions.

2) If he finds that the system of internal check is sound, he should adopt the following lines.

a) He should find out find out the system of petty cash book.

b) He should ascertain the name of the petty cashier to the amount of the imprest.

c) He should check some petty cash payments at random with the vouchers to ensure the correctness of the petty cash payments.

d) He should see that all petty cash payments over a certain amount are supported by proper vouchers.

e) He should see that petty cash payments not supported by proper vouchers are supported by slips by the officer who have spent the amounts.

f) See that the petty cash book is periodically checked and initiated by some responsible officer.

g) See that the petty cash balance as shown in the petty cash book agrees with petty cash balance as shown by petty cash account.

h) He should check the casting of total payment column and the individual expenses column.

i) He should physically count the petty cash balances on the balance sheet date. If he fails to do so, he will be held liable for damages. This was upheld in the case of London Oil Storage Company Limited v/s Sears Hasluck and Company.

j) He should see that I.O.Us is not included in the petty cash balances.

VOUCHING OF TRADING TRANSACTIONS

Vouching of trading transaction is concerned with credit purchases, credit sales, purchase returns, and sales returns are entered in the purchase book, sales book, purchase return book and sales return book respectively. So vouching of trading transactions also means that vouching of purchase book, sales book, purchase return book, and sales return book.

One main object of vouching of trading transaction is to detect misappropriation of goods, if any.

VOUCHING OF CREDIT PURCHASES OR VOUCHING OF PURCHASE BOOK

The main objective of vouching of purchase book or credit purchases is to ensure that all purchase invoices are entered in purchase book, that goods entered in the purchase book are actually received and the business pays only for those goods which are delivered by the suppliers.

Firstly, an auditor should examine the system of internal check in force in the business in regard to credit purchases. If the system of internal check is not sound, he should check all the entries in the purchase book in detail. If the system of internal check is sound, he need not check all the entries in the purchase book in detail. He has to vouch the credit purchases on the following lines:

1) He should examine the inward invoices from which entries are made in the purchase book. While examining an inward invoice, an auditor should pay attention to the following points:
   a) The invoice is in the name of the client.
   b) The date given in the invoice relate to the period under audit.
   c) The invoice is related to the business in which the concern deals.
   d) The invoice is initiated by a responsible officer.
   e) The trade discount has been deducted from the amount of invoice and then only net amount has been entered.
   f) Quantity mentioned in the purchase invoice tallies with the quantity recorded in the purchase book.
2) He should check the purchase invoices with the purchase book, where the credit purchases are recorded.
3) He should see that only credit purchases are recorded in the purchase book.
4) He should see that purchases not made for the business are not recorded in the purchase book.
5) He should see that purchases of capitals assets are not included in the purchase book.
6) He should see that all goods received prior to the date of closing and taken into stock are recorded in the purchase book.
7) He should see that goods entered in the purchase book but not received are included in the closing stock.
8) He should verify some of the purchase invoices with the goods inward book, stock records and The challans from the suppliers to see that the goods have actually received.

9) He should compare some of the entries in the purchase book with the order book and goods inward book to ensure that no fictitious purchases are recorded and no invoice is entered twice.

10) To ensure that all invoices are included in the purchase book, the auditor should obtain the statement of accounts from the creditors and examine them.

11) He should make a list of all invoices missing or not available.

12) Where contracts for forward purchases are entered into, the auditor should see that they are not abnormal. If they are abnormal in amount, he should see that it is mentioned in the balance sheet by way of note.

13) He should check the casts and carry forwards to the purchase book.

14) He should check the postings from the purchase book to the purchase account as well as to the creditors account.

15) He should check carefully the purchase made in the first month and the last month of the accounting year, because, sometimes, purchases made in the last month of the last year may be included in the purchase of the current year or purchase made in the last month of the current year may be included in the purchases of the first month of next year.

VOUCHING OF CREDIT SALES OR VOUCHING OF SALES BOOK

Outward invoices, which are the vouchers for the credit sales, are not completely reliable, as they are prepared by the staff of the business. So an auditor has to very careful in vouching credit sales.

Firstly he should examine the following lines:

1) He should examine the outward invoices from which entries are made in the sales book. While examining the outward invoices, he should pay attention to the following points:

a) See that name of the customer stated in the outward invoice agrees with the entry in the sales book.

b) The date given in the outward invoice relate to the period under audit.

c) The invoice is initiated by a responsible officer.

d) See that trade discount allowed is deducted from the sales price and net amount has been entered.

2) He should check the outward invoices with the sales book, where the credit sales are recorded.

3) He should check the sales book with the order received book and see that the sales are genuine and all the sales are included in the sales book.

4) After the examination of outward invoices, the auditor should see that they are cancelled by stamping out and all the cancelled invoices are kept together for verification.

5) He should see that only credit sales are recorded in the sales book.
6) He should see that sales of capital assets are not included in the sales book.
7) See that good sent on sales or return or on consignment are not entered in the sales book.
8) He should see that good sold, but not delivered are not included in the closing stock.
9) He should check the casts and carry forwards of the sales book.

10) He should check the postings from the sales book to the sales account and customer accounts in the ledger.

11) He should check carefully the sales made in the first month and the last month of the accounting year, because, sometimes, sales made in the last month of the last year may be included in the sale of the current year or sale made in the last month of the current year may be included in the sales of the first month of next year.

12) If the trade discount allowed during the current year is exceptionally high, the auditor should enquire in to the reasons for the same.

13) Where the sales are subject to sales tax, the auditor should see that the sales tax collected is Separated from the sales price, and is shown in a separate column in the sales book.

14) Sometimes, fictitious sales are included in the sales book to inflate the sales and the gross profit, an auditor has to take necessary steps to discover such fictitious sales.

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Vouching purchase returns or purchase returns book.

An auditor should undertake vouching of purchase returns on the following lines:

1) He should enquire into the system of recording of purchase returns.
2) He should vouch the purchases returns book with the credit notes received from the creditors.
3) He should examine the goods outward book and the related correspondence to ensure that there is no suppression of purchase returns.
4) He should check the casts and carry forwards of purchase returns book.
5) He should check the postings from the purchase returns book to the purchase returns

account and customers account in the ledger.

6) He should check carefully the entries in the purchase returns book for the first month and for the last month of the year to ensure that there is no manipulation of accounts.

Vouching of sales returns or sales returns book

1) He should enquire into the system of recording sales returns.
2) He should vouch the sales returns book with the credit notes issued.
3) He should examine the goods inward book and the related correspondence to ensure that there is no suppression of sales returns.
4) He should check the casts and carry forwards of sales returns book.
5) He should check the postings from the sales returns book to the sales returns account and customers account in the ledger.
6) He should check carefully the entries in the sales returns book for the first month and for the last month of the year to ensure that there is no manipulation of accounts.

Vouching of journal proper

Journal proper is meant for recording all those transactions which cannot be recorded in the other subsidiary books viz purchase book, sales book, purchase return book, sales return book, cash book, B/Rbook, B/P book. The following entries are recorded in the journal proper:

1) Adjusting entries.
2) Transfer entries.
3) Closing entries.
4) Rectification entries.
5) Entries for purchase and sale of assets on credit.
6) Opening entries.
7) Entries for consignment.
8) Entries for application for shares, allotment on shares and calls on shares. An auditor should vouch the journal proper on the following lines:

1) He should see that every entry in the journal proper is supported by a voucher or evidence. 2)He should see that every entry in the journal proper is explained by narration.

3)When the evidences are not available for some entries in the journal proper, the auditor should check those entries from the evidence of parties.

Verification of assets and liabilities.

Verification means ‘proving the truth’ or ‘confirmation of the truth’. Verification of assets and liabilities means proving the truth about the existence and the correctness of the money value of the assets and liabilities appearing in the balance sheet of the business. In other words, it means establishing the actual existence of the assets and liabilities appearing the balance sheet, ownership and possession of the assets and proper classification and valuation of assets and liabilities.

Objects of verification of assets and liabilities.

1) To find out whether assets and liabilities shown in the balance sheet actually exist.
2) To ascertain whether the assets and liabilities appearing in the balance sheet are shown at their correct values.
3) To confirm the possession and ownership of the assets appearing in the balance sheet.
4) To find out whether there is proper classification of assets and liabilities.
5) To check the arithmetical accuracy of the books of accounts.
6) To ascertain whether the balance sheet gives a true and faire view of the financial position of the business.

Difference between vouching and verification.

1) ***Nature:-***vouching is the examination of the business transactions recorded in the books of original entry, whereas verification is the examination of assets and liabilities appearing in the balance sheet.
2) ***Objectives:-*** vouching is done to examine the correctness and the authenticity of the business transactions recorded in the books of original entry. But verification is undertaken to confirm the values of assets and liabilities of the business as shown in the balance sheet.
3) ***Work begins:-***verification of assets and liabilities are undertaken after the vouching of the books of accounts. In other word, verification begins where vouching ends.
4) ***Time:-***vouching is done throughout the year, whereas verification is done at the end of the year after the balance sheet is prepared.
5) ***Scope:-***vouching does not include valuation of assets. But verification of assets includes the valuation of assets.
6) ***Utility:-***vouching of books would only indicate that a particular assets or liabilities ought to exist. It does not indicate whether a particular assets or liabilities really exist at the date of the balance sheet. But verification proves whether the assets or liabilities really exist at the date of the balance sheet.
7) ***Basis:-***vouching is based on documentary examination. On the other hand verification is based on physical as well as documentary examination
8) ***Personnel:-***vouching is done by the staff of the auditor. But verification is done mostly by the auditor himself.
9) Valuation of assets.

Valuation of assets means the determination of or the ascertainment of the money value at which the assets are shown in the balance sheet. However in audit it implies critical examination and testing of the determined values of the assets on the basis of generally accepted accounting principles. In short, it is the process of ensuring that the money value of the asset as shown in the balance sheet has been properly determined.

Objectives.

1) To verify whether the assets shown in the balance sheet have been properly valued.
2) To indicate that the balance sheet represents a true and fair view of the financial position of the business.
3) To indicate that there is no manipulation of account to inflate or reduce the profit.

Auditors duty in regard to valuation of assets

Valuation of assets is a difficult task. It requires technical knowledge. But an auditor has neither technical knowledge nor the time required for the valuation of assets. So an auditor can't be expected to do the valuation of assets. In short an auditor is not a valuer. The valuation ofassets is done by the officials of the business. Auditor has only to make an enquiry into the valuation of assets andsatisfyhimselfthatthevalueofassetsareproperlydetermined.Thisview was upheld in many cases. For example, the Kingston Cotton Mills company's case, it was held, it is no part of an auditor's duty to take stock. He must rely on other people for the details of the stock.

An auditor has to critically examine the valuation and satisfy himself that valuation of assets has been properly made to satisfy himself that the values of assets are correct, an auditor should do the following:-

1) He should obtain all information available in respect of the valuation of assets.
2) He should critically examine and analyze the all figures of the valuation of assets.
3) He should verify whether the principles and practice of valuation of assets have been consistent from year to year.
4) He should verify whether the value of assets have been determined properly in accordance with the generally accepted accounting principles.
5) Wherever necessary he should take the assistance of technical experts for valuing the assets.
6) He should ascertain whether current values of assets are fair and reasonable.

If the auditor does not exercise proper care and skill in the matter of enquiry into the valuation of assets. He will be held guilty of negligent or fraud. This was upheld in many cases-

For example, in the case of Lease Estate Building & investment v/s shepherd, the auditor was held liable for the dividend paid out of the capital for several years, based on the wrong financial statement.

Classification of assets/types of assets for the purpose of valuation & mode of valuation

1)Fixed assets

They are acquired for permanent use in the business. It is not for resale in the ordinary course of business but for the purpose of enabling the business to earn profit. These assets will be in use for a pretty long period. Examples are land, building, plant, machinery, etc. Fixed assets are to be valued at original or historical cost less total depreciation written off (Going concern value).

2) **Current assets (circulating or floating assets)**

Current assets are those assets, which are acquired for resale or produced for the purpose of sale or converting them in to cash. Examples are stock, semi-finished goods, book debts, cash and bank balance, etc…..

Cash and bank balance- no valuation required

Book debts and bills receivable- valued at book value

Raw materials- first in first out or last in first out or average cost method Closing stock-at cost price or market price whichever is lower.

3) **Intangible assets**

Intangible assets are those assets, which cannot be seen or touched. Examples are good will, copyrights, patent etc. these assets are shown at cost price.

4) **Wasting assets**

Wasting assets are of fixed nature, which are depleted gradually or exhausted in the process of earning income. Examples are mines, quarries, oil wells etc. These assets are valued at original cost less provision for depletion.

5) **Fictitious assets**

These are neither physically visible nor realizable into cash. They are revenue expenditure that have been temporarily capitalized with the object of generating the amount over a period of years the benefit of which accrues. Examples are preliminary expenses, discount on issue of shares, advertisement suspense account etc.

6) **Contingent assets**

These are assets the existence, values and ownership of which depends upon the occurrenceofaspecifiedevent.Examplesareclaimforrefundofincometax, sales tax.

Various values used for valuation.

1) Cost price.
2) Market price.
3) Replacement.
4) Realized value.
5) Book value.
6) Breakup value.
7) Going concern value.

Difference between verification and valuation

Nature:- In verification of assets, an auditor verify not only the actual existence of the assets but also their proper valuation. But in the case of valuation of assets, an auditor has to merely ensure that the values of the assets as shown in the balance sheet are correct.

1) Scope: - Verification includes valuation also. Valuation is a part of verification of assets.
2) Work begins:-Verification of assets comes in before the valuation of assets but valuation of assets follows verification of assets.
3) Responsibility:-In the case of verification of assets, the auditor is entirely responsible for the work. But in the case of valuation of assets is done by the owners. The auditor merely ensures that the values of the assets as shown in the balance sheet are correct.
4) Guarantee: - In the case of verification of assets, the auditor gives guarantee that the assets have been properly verified. But in the case of valuation of assets he does not give any guarantee.
5) Basis:-Verification of assets can be made by an auditor on the basis of physical inspection as well as documentary evidences. But for valuation of assets, he depends up on the estimates

   of the proprietor.
6) Chance of fraud:-In verification of assets, the chances of manipulation of accounts to inflate or deflate profit is less, but in valuation of assets, there is more chance of such frauds.

Classification of liabilities for valuation.

Current liabilities

Current liabilities are those liabilities of the business, which are short-term liabilities. They are to be settled within a period of one year. Examples are trade creditors, bills payable, outstanding expenses.

Fixed liabilities

These are of long-term nature. Examples are long term loans borrowed, long term deposit received.

Contingent liability

It is not an actual liability. It may become a liability on the happening or non-happening of certain events in future. In short it is a liability which may or may not arise in the future for payment. Examples are liabilities in respect of bills discounted, guarantee given, compensation pending.

Verification and valuation of different assets.

1)**Freehold property**

Freehold property refers to the land and building which is absolutely the property of the business. While undertaking the verification and valuation of freehold property an auditor should observe the following points:

1) Examine the title deeds

He should examine the title deed relating to freehold land& building to ensure that they are in the name of the client. If there is any doubt relating to title of property, he should consult solicitors of the client.

2) Examine the conveyance or brokers account

If the freehold property has been purchased, he should examine the correspondence, conveyance deed and broker's or auctioneer's account. If the freehold property is consist of building constructed by the client the auditor should ask for and examine the architect's and the builder's certificates.

3) Capitalization of expenses

He should see that if legal expenses, brokerage and other expenses are incurred for the acquisition of freehold property, they are capitalized.

4) Mortgage of freehold property

If the freehold property mortgaged, auditor should get a certificate from mortgagee stating that the title deed are in his possession. He should also make proper enquiry to ensure that there is no second mortgage on the freehold property. If the title deeds of the freehold property are with a bank or solicitors for safe custody the auditor should get a certificate from the bank or the solicitor stating that they are held by him for safe custody and not as a security for any loan.

5) Additions to free hold property

He should check additions to the freehold property, if any, made during the year with the help of relevant vouchers. He should also see that the cost of additions is capitalized.

6) Sale of freehold property

If any freehold property sold during the year, an auditor should check such sales and see that profit or loss thereon is correctly dealt within the accounts.

7) Repairs and renewals

He should see that repairs and renewals of freehold property are charged to revenue account.

8) Provision for depreciation

He should examine the adequacy of provision for depreciation on free hold building.

9) Appreciation of freehold building

If any appreciation of free hold building is taken into account, the auditor should

See that appreciated value is clearly disclosed in the balance sheet. He should also obtain a certified copy of valuation of the property from a professional valuer.

10) Shown in the balance sheet

See that the free hold properties are shown separately in the balance sheet under the head fixed asset. He should also see that freehold property is shown cost less depreciation. In case freehold property is shown in the balance sheet in market value, the auditor must see that they are clearly mentioned in the balance sheet.

2). **Leasehold property**

Lease hold property refers to land and building acquired by a business for a fixed period on lease. While undertaking the verification and valuation of lease hold property an auditor should observe the following points.

1) Examine the lease deed

He should examine the lease deed to ascertain the cost of lease hold property, the duration of the lease, terms and condition of the lease.

2) Registered

If the lease is for more than one year the audit or should see that the lease deed is registered.

3) Amount capitalized

He should see that amount paid for lease property is capitalized.

4) Examine the receipt for the lease

He should see that the lease rent is paid regularly and lease is existing. For this purpose he should examine the last receipt of the payment of rent.

5) Examine the agreement with sub tenant

He should see that the agreement with the subtenant is if it is sublet to others.

6) Addition to lease hold property:-

Verified with relevant vouchers that see that amount paid is capitalized.

7) Repairs and Renewals:- See that it is charged to revenue.

8) Provision for depreciation Shown in the balance sheet

3). **Plant and machinery**

While undertaking the verification and valuation of plant and machinery an auditor should observe the following points.

1) Examine the plant register

He should examine the plant register if it is maintained by concern.

2) Examine the schedule of plant and machinery

He should call for and examine the schedule of plant and machinery signed by the engineer.

3) Verify the plant and machinery purchased

He should verify the plant and machinery verified, plant and machinery purchased with the original invoice and agreement with the ventures.

4) Check the plant register with plant and machinery account

To ensure plant and machinery account and satisfy himself as to the value of plant and machinery.

5) Addition to the plant machinery

6) Sale and plant and machinery

7) Repairs and renewals 8) Provision for depreciation 9) Shown in the balance sheet

4). **Furniture and fixtures**

While undertaking the verification and valuation of furniture and fixtures an auditor should observe the following points.

1) Examine furniture stock register

2) Verify the price of furniture purchased with invoices and receipts

3) Physical verification -He should verify the physical existence of furniture by personal inspection.

4) Addition to the furniture and fixture

5) Sale of furniture and fixtures

6)<u>Provision for depreciation</u>

7)<u>Method of depreciation</u>

He should enquire into the method of depreciation as the amount on depreciation depends upon the use of the asset and the method of depreciation adopted.

8) <u>Un serviceable furniture written off</u>

He should see that the unserviceable furniture and fixtures are written off under proper authority.

9) <u>Shown in the balance sheet</u>

4) <u>Valuation of goodwill</u>

Goodwill is the value of reputation of an organization which enables the business to earn more than the normal rate of profit.

While undertaking verification and valuation of goodwill an auditor should observe the following points;

1)<u>Goodwill purchased along with running business</u>

When goodwill has been purchased along with running business from some vendors the amount of goodwill should be verified by the auditors from the purchase agreement with vendors, showing the price paid for the goodwill.

Where the price paid for the goodwill is not specifically fixed, auditor should ensure that the amount of goodwill taken into account is the amount of purchase consideration, i.e, amount of purchase consideration over net assets taken over.

2)<u>Goodwill arise by writing up the value of assets</u>

When goodwill account has been arise by a company by writing up the value of its assets or the revaluation of assets, the auditor should examine the basis on which assets have been revalued and satisfy himself that the amount of goodwill brought into account is proper.

3)<u>Goodwill created in the books of partnership firm</u>

The amount of goodwill created in the book of partnership firm on the admission of a new partner or on the retirement or on death of an existing partner, should be verified by the auditor with the help of with the help of the partnership deed. The auditor can also verify the changes made in the goodwill account from time to time on the basis of the provisions of the partnership deed.

4) Valuation of goodwill

Valuation of goodwill is a matter of financial policy, to be decided by the management of the business. The auditor can't interfere in the valuation of goodwill, though he may give his advise on the valuation of goodwill. For the valuation of goodwill the auditor is just to see that the goodwill is shown in the balance sheet at its proper value.

5) Insist upon writing off goodwill

If it appears to him that the future benefit associated with the goodwill does not exist, he should insist on writing off the goodwill.

6) Shown in the balance sheet

An auditor should see that goodwill valued at cost less amount written off and shown in the balance sheet. An auditor should see that goodwill valued at cost less amount written off and shown in the balance sheet.

7) Verification and valuation of patent right

1) Examine the schedule or list of patent right.
2) Verify the patent right with the help of certificates of patents.
3) Ensure that the patents have registered in the name of the client.
4) Patent right are developed by the research work

If the patent right are developed by concern by doing some research work, the cost of research and development should be capitalized. Similarly if the patent right have been purchased, the cost of purchases of patent should be capitalized.

5) Renewal fee should be charged to revenue.

6) Cost of patent written off-An auditor should see that the cost of patent written off. If a patent becomes obsolete, the entire book value should be written off.

7) Shown in the balance sheet. See that the patents are shown in balance sheet 8). **Verification of investment**

1) Examine the schedule of investment -He should call for and examine the schedule of investment held by the client with reference to the relevant ledger accounts.

2) Physical verification -If investment is in the hand of the client, auditor should verify the existence of the investment by personal inspection. If it is entrust to a bank

for safe custody, he should get a certificate from the bank, giving the details of the security in its hand and stating that they are free from any charge. If an investment is held by a trustee on behalf of the company, the auditor should call for and examine the trust deed. If the securities are held by the client brokers, the auditor should call for securities for personal inspection. If the securities deposited with bank or any other creditor as a security towards loans borrowed, an auditor should get a certificate from bank or creditor to this effect.

3) Purchase of investment -If securities are purchased during the year, he should verify the purchase by examining the certificate. If no certificate is available he should examine purchase with the help of transfer deed and broker's bought note.

4) Transfer fee, stamp duty etc. –He should see that transfer fee, stamp duty etc incurred on the purchase of investment are properly capitalized.

5) Sale of investment -If the securities are sold during the year, the auditor verify the sale price with the help of broker's sold note. See that the sale is approved by board of directors. See that whether the profit or loss made on sale is properly adjusted in the accounts.

6) Registered in the name of the client-He should ensure that the investment is registered in the name of the client and they are free from charges other than those disclosed.

7)Properly valued-Satisfy himself that investment is properly valued.

8)Shown in balance sheet -See that the investments are shown in balance sheet at market or cost price

9)Verification of cash in hand

1) Physically count the cash in hand

The auditor should actually count the cash in hand by attending the business premise on the last day of the financial year. Actual verification of cash in hand has been considered to be the most important part of an auditor's duty. It was upheld in many cases. For instance, London oil storage company ltd v/s Secer Husluck &co. In this case it was held that the auditor has committed a breach of duty in verifying the existence of the pretty cash balance.

2) Surprise visit to business premises

To prevent manipulations & fraud the auditor can pay a surprise visit to the business premises of the client.

3) Count different kinds of cash balances simultaneously

If there are different kinds of cash balances say petty cash in hand and cash in hand, the auditor should count them simultaneously. Shortage on one account may not be made up from another account.

4) Count currency notes, coins, stamps and I.O.Us

He should count on closing date not only currency notes and coins but also the stamp and I.O.Us in hand, as they are also part of cash balance.

5) See that I.O.Us are genuine.

6) Physically count the stock of the unsold canteen tickets, lunch coupons etc as they are likely to be converted into cash.

7) Compare the cash in hand as revealed by physical counting with the cash balance as shown by the cash flow.

8) Verify cash transactions with the proper documentary evidences and correspondence.

9) Shown in the balance sheet.

10). **Verification of cash at bank**

1) Compare bank balance as shown by the cash book with the bank balance as shown by the bank pass book.

2) Preparation of bank reconciliation statements-If there is some difference between these two balances; he should prepare a bank reconciliation statement.

3) Obtain separate certificate for fixed deposit account, savings bank account, current account etc… He should obtain separate certificate from the bank to verify balances of the different types of bank accounts.

4) Verify all of the bank accounts individually-In case there are accounts with more than one bank the auditor should verify them individually.

5) See that necessary adjustments are made in respect of interest accrued on fixed deposit.

6) See that Cheques not yet collected are genuine.

7) In case money is kept with other agencies, the nature of interest and the name of the agencies should be disclosed by the auditor in his audit report.

8) Where large amounts are held in foreign banks, the fact should be disclosed by the auditor in his audit report.

9) Shown in the balance sheet

11). **Verification of bills receivable**

1) Examine each bill in hand to ensure that it is properly drawn, sufficiently stamped

and duly accepted by the accepter.

2) Verify the bills receivable given in the balance sheet by obtaining certified schedule of bills in hand.
3) Compare the schedule of bills in hand with bills receivable book and bills receivable account.
4) See that overdue bills are not included in the bills in hand.
5) Bills discounted should be examined by referring the cash book and pass book.
6) See that bills discounted or endorsed but not yet met are treated as a contingent liability and are indicated by way of foot note in the balance sheet.
7) See that proper provisions are made for contingent liability on bills discounted.

8) Shown in the balance sheet

9) Verification of debtors

1) Examine the schedule of debtors.
2) Verify the schedule of debtors with the help of sales ledger or debtor's ledger.
3) Verify the sales ledger balances with the help of sales book, sales returns book, cash book etc.
4) See that the book debt shown in the balance sheet is recoverable.
5) Obtain a certificate from a responsible officer in respect of statement of book debt.
6) See that proper provision is made for discount on debtors.
details.
7) Debts due from subsidiary company should be carefully inspected by the auditor.
8) In case of debt in a foreign company, the auditor should find out, by converting the amount into home currency.
9) In case the client is a company, the auditor should see that the book debts are classified for balance sheet purpose as required by the companies Act1956. That is book debts are classifies as follows,

- Debts considered good in respect of the company is fully secured.
- Debts considered good for which the company holds no security other than the debtor's personal security.
- Debt considered doubt full.

Further debt due by directors or officials of the company either severally or jointly with any other person shown separately. Again debt due from other company under the same management should be disclosed with the names of the companies.

13) Verification of loans advanced

Generally loans advanced will be of the following types:-

1) Loans against the security of land & building.
2) Loans against the security of stock & shares.
3) Loans against the security of goods.
4) Loans against the security of life policies.
5) Loans against the security of guaranty of a third party.
6) Loans against the personal security of the borrower

While verifying the loan advanced, an auditor should keep in mind the following points:

1) Examine the schedule of loans granted.
2) Verify the loans advanced with the help of loan agreement, application of loans, acknowledgements of receipts, and loan account in the ledger.
3) Examine the authority of person granting the loans.-Ensure that the loans advanced are within the powers of the person granting the loans.
4) Ascertain the worth of the securities-In the case of secured loans, the auditor should ascertain the worth of securities offered and see that sufficient margin is maintained.
5) Examine the credit worthiness of the borrower-In the case of unsecured loans, the auditor should examine the credit worthiness of the borrower and ascertain the possibility of their recovery.
6) See that outstanding loans are confirmed by the borrowers.
7) See that interests on loans are regularly collected.
8) See that provisions are made for doubtful loans.
9) In the case of joint stock Company, the auditor should see that the loans are properly classified.
10) See that loans to directors and officials of the company are shown separately in the balance sheet.
11) See that the advances to subsidiary companies are shown separately in the balance sheet.

12) See that loans are shown separately in the balance sheet.

a) Loans against the security of land and building

b) Examine the loans granted with the help of loan agreements.

c) Examine the powers of the person granting the loan.

d) Examine the memorandum and articles of association, in the case of joint stock companies.

e) Inspect the minutes of meeting of the board of directors and see that loans are properly sanctioned.

f) Verify the details of the loan.

g) See that outstanding loans are confirmed by the borrowers.

h) Examine the title deed relating to the property mortgaged.

i) Interests on loans are collected regularly

2) <u>Loans against the security of stock& shares</u>

1) Examine the loans granted with the help of loan agreements.

2) Examine the list of stocks and shares held by the company.

3) See that shares offered as security is transferred to his client.

4) Check the value and see that there is sufficient margin between the loan and the present value of the security.

5) See that shares accepted as security are fully paid up.

3) <u>Loans against the security of goods</u>

1) Examine the loans granted with the help of loan agreements.

2) Examine the powers of the person granting the loan.

3) Examine the godown keeper's receipt, dock warrant if loans are advanced against the goods lying in warehouse.

4) See that godown rent is paid regularly by the borrower.

5) See that goods offered as security are fully insured.

6)See that goods offered as security are easily saleable.

4) <u>Loans against the security of life policies</u>

1) Examine the loans granted with the help of loan agreements.

2)Examine the powers of the person granting the loan.

3)Enquire into the class of insurance policy.

4) Examine the last receipt for the payment of insurance premium.

5)Ascertain the surrender value of the life insurance policy.

5) <u>Loans against the guaranty of a third party</u>

1)Examine the loans granted with the help of loan agreements.

2)Examine the powers of the person granting the loan.

3) Examine the guaranty.

4) Enquire into the financial position of surety.

6) <u>Loans against the personal security of the borrower</u>

1)Examine the loans granted with the help of loan agreements.

2)Examine the powers of the person granting the loan.

3)Examine the credit worthiness of the borrower.

4)Finally auditor should discourage the client granting of such loans.

14). **<u>Verification andvaluation of stock in trade</u>**

The work of verification and valuation of stock in trade consist of two elements, 1)Verification of stock in trade.

2)Valuation of stock in trade.

i) Verification of stock in trade does not mean merely the checking of stock statements.

While verifying stock in trade, an auditor should keep in mind the following points,

1) 1)Examine the system of internal check with regard to the verification of stock in trade.
2) Obtain copies of physically out of all plant, giving names and descriptions of all departments where stocks are held.
3) Obtain details as to the quantity and value of stock with each department. 4)Secure a copy of stock taking instructions issued to the staff.
4) Ensure that proper and adequate records of stocks have been maintained.
5) See that goods which are not related to the business are not included in the stock.
6) 7)See that goods sold prior to the closing date are not included in the stock.
7) 8)See that items of capital nature are excluded from the stock. 9)He should test check physical existence at least 5 % of items
8) See that stock held by third party is included in the stock sheet.

9) Compute Work out ratio between gross profit and sales of current year and compare it with that of the previous year.
10) Compare stock sheet of current year with that of previous year.
11) Check calculations, additions and castings in the stock sheet.
12) See that stock sheet is initiated by a responsible person.
13) See that goods taken into stock sheet are passed through the purchase book.

Methods of valuation of stock in trade

- Actual cost price method
- Simple average cost method
- Weighted average cost method
- FIFO
- LIFO
- Base stock method
- Standard cost method
- Market price method
- Net realized value method

Valuation of different items of stock in trade

1)Raw materials are valued at cost price plus proportionate freight and import duty.
2)Work in progress: cost price of raw materials plus proportionate amount of manufacturing
expenses plus a percentage to cover the establishment charges relating to manufacture.
3) Finished goods: principal of “cost price or market price which ever is lower” is applied.
4) Spare parts: cost price
5) Stores articles: cost price
6) Stock of special trade: cost price plus interest at remarkable rate plus expenses of maintaining stock.

Verification andValuation of liabilities

1.See that the liabilities are neither deliberately omitted nor under stated nor overvalued. 2.See that the liabilities are shown in balance sheet at their correct amount.

3. Obtain a certificate from responsible officer as to the correctness of the amount of different liabilities.

1) Verification of sundry creditors
2) While verifying sundry creditors an auditor should bare in mind the following points:
3) Obtain a list of creditors-He should get a schedule or list of creditors from the management and verify whether the schedule contains all the details about creditors.
4) Check the schedule of creditors with the balance in the creditor's ledger. 3)Obtain statement of account from creditors.
5) 4)Check the purchase book and purchase return book with the help of invoices and credit notes. 5)Check the postings from subsidiary books to the creditors account in the ledger.
6) 6)Examine the purchase invoices to ensure that these are related to current year. 7)Compare the percentage of gross profit of current year with that of the previous year.
7) Special attention to the entries made either at the beginning of the year or at the end of the year.
8) Check the provisions for the discount on creditors with the help of reference to the creditor's ledger. If the credited amount is unpaid for a long period, enquire the reasons.
9) See that creditor's amount shown in the balance sheet are correct.
10) Verification of bills payable

a) Obtain a schedule of bills payable
b) Check the total of schedule of bills payable with the bills payable book and the bills payable account.
c) Verify the payments made to the bills payable with the entries in the cash book.

d) 4)Verify the bills payable returned under rebate.
e) Satisfy himself with the genuineness of bills payable.
f) See that the bills payable which have been paid are not shown as outstanding.
g) Check the bills payable paid after the balance sheet date but before the date of the audit with the entries made in the cash book.
h) See that the bills payable amount shown in the balance sheet are correct.

3). <u>Verification of bank overdraft</u>

1. Examine the overdraft agreement with the bank.
2. Check the cash book with the bank pass book.
3. Obtain a certificate from the bank and verify the correctness.
4. 4)Verify the outstanding interest, if any.
5. 5)If bank overdraft is secured, see that the assets charged against such loans are clearly stated in the balance sheet.

4). <u>Verification of loans &advances borrowed</u>

1. Examine the loan agreement.
2. Examine the loans and advances with the help of the correspondence and relevant documents.
3. 3)Ensure that loans and advances are taken for the use in the business.
4. 4)Check the amount of loans and advances with the confirmation letters received from lenders.
5. 5)If the loans are secured examine the amount of secured loans, nature and value of securities.
6. 6)See that interest on loan is paid or not.
7. 7)See that loans are separately shown in the balance sheet as secured and unsecured.

5). <u>Verification of debentures</u>

1. Examine the memorandum and articles of association to ensure that the borrowing limit is not exceeded.
2. Examine the debenture account to verify the debentures issued.
3. Examine the debenture trust deed to verify amount of debenture issued and securities offered.
4. 4)If debentures are issued at premium or discount, see that premium and discount

are properly

5. dealt with in the books of account.
6. If debentures are to be redeemed after some years, he should see that arrangements are made for the same.
7. See that debentures shown in the balance sheet are correct.

6). <u>Outstanding expenses</u>

1) Verify the outstanding expenses with the help of statement of outstanding expenses certified by a responsible officer.
2) Compare the outstanding expenses of current year with those of previous year to see whether there is any material difference.
3) See that outstanding expenses have been subsequently paid.
4) Verify the item of expenses such as salaries, wages, rent etc which remain outstanding. 5)See that outstanding expenses are clearly shown in the balance sheet.

7). <u>Income received in advance</u>

1) Verify the item of incomes which are normally received in advance with the help of list of incomes received in advance certified by a responsible official.
2) See that these are fully disclosed in the balance sheet.

DEPRECIATION

The term "Depreciation" is not defined in any act. It is the term of accountancy. It may be defined as the decrease in Book value of assets on a account of natural wear and tear and lapse of time. It is also be defined as a gradual diminishing, loss or shrinkage in the utility value of an assets.

CAUSES OF DEPRECIATION

a. Depreciation arises due to use, obsolete, exhaustion etc. :

b. The depreciation is charges in particular proportion in each accounting year.

METHODS OF DEPRECIATION

a) Straight line or fixed instalment system
b) Reducing balance method.
c) Annuity method
d) Sinking fund method

e) Insurance policy system

f) Machine hour rate

g) Revaluation method

h)Production unit method

DEPRECIATION OF ASTING ASSETS

If depreciation is not provided for the wasting assets. The profit and loss account and Balance sheet may not show the true and fair view and more over sufficient funds may not be available for replacement of the assets after it becomes duly depreciated.

RESERVES

It is a proportion of profit and it denotes that amount which is kept aside for emergency likely to arise in the future.

TYPES OF RESERVES

(a) Special Reserve – When the profit is appropriated and transferred to a reserve created for special purpose, it is called “special Reserve”. Example: Staff welfare measures, Debenture redemption reserve, dividend equalization reserve.

(b) General Reserve: A General Reserve is created out of profits to meet the unknown liabilities every year a certain sum of money is transferred out of profit to general reserve.Example: Meeting long term liability, Expansion of Business, Meeting unexpected liability.

(c) Sinking Fund: It is created for the purpose of redemption of liabilities arising out of issue of debenture and othr loans.

(d) Capital Reserve: It is carried out of capital profit and it its not available for distribution as reserve. It can be created by transferring profit from

(i) Revaluation of assets

(j) Sale of fixed assets

(k) Redemptiom of debentures and share premium.

(e) Special Reserve- It is a change against profit. A provision is made for meeting a liability which is known but the asset cannot be accumulated.

(f) Secret Reserve: It is known as “Hidden Reserve”, inner reserve or internal reserve. Secret reserve is not disclose in the Balance sheet under secret maintaining. Example: Understanding the stock value, Writing as Capital expenditure as though revenue expenditure, making excess provision for contingent liability, depreciation for bad and doubtful debts.

PART –A

1. Define Voucher.
2. Define Vouching.
3. What do you mean by window dressing?
4. What are the important features of vouchers?
5. Briefly explain the various method of window dressing
6. What are the documents to be verified while vouching the receipt of insurance claims?
7. Define verification of assets.
8. What are the objects of verification of assets?
9. What do you mean by miscellaneous expenditure?
10. Name the expenses that are included in miscellaneous expenses.

PART–B

1. Explain the differences between routine checking and vouching?
2. Explain the characteristics of an effective internal control system relating to cash transactions?
3. Discuss the various steps involved in vouching of cash transactions?
4. Explain the audit of fixed assets?
5. Explain the verification of Intangible assets?
6. What are the responsibilities of the auditors as regards inventories?
7. What is meant by Depreciation? Explain in detail about depreciation of wasting assets?
8. Explain the various types of Reserves?
9. Explain the verification of liabilities?
10. “Capital and Revenue Expenditure”- Comment.

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SCHOOL OF MANAGEMENT STUDIES

UNIT IV - PRACTICAL AUDITING – SBAA3001

COMPANY AUDITOR

According to Section 224 of the Companies Act, every company whether private or public must appoint an Auditor or auditors to audit the final accounts. The provisions relating to the appointment of auditor are as follows:

1. Board of Directors:

The first auditor of a newly floated company is appointed by the board of directors, within one month of registration of the company. Such an auditor or auditors shall hold office till the conclusion of the first annual general meeting.

The directors are also empowered to fill a casual vacancy of an auditor if it is not caused by resignation. The auditor so appointed shall hold office till the conclusion of the next annual general meeting. But in case, if the vacancy is caused by the resignation of an auditor, it shall only be filled by the company in its annual general meeting.

2. Annual General Meeting:

The auditor or auditors are appointed in the annual general meeting under the following circumstances:

1) If the board of directors fails to appoint an auditor, the shareholders shall make an appointment in the annual general meeting.
2) Every company shall at each annual general meeting appoint an auditor to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.
3) The company has to give intimation to the auditor so appointed within seven days of his appointment.
4) The auditor so appointed shall within 30days of the receipt of intimation from the company regarding his appointment, has to inform the registrar of the company in writing whether he has accepted or refused the appointment.

In every annual general meeting the appointment of the company's auditor is made by the simple majority of votes by the present members.

3. Central Government:

According to section 224 (3), if the auditor has not been appointed in the annual general meeting, the company has to inform within seven days to the Regional Director to whom the Central Government's power to appoint an auditor in such an event has been delegated under section 637. The said application must disclose in sufficient detail the reasons why the company could not appoint the auditor at its general meeting. In the case of default, the company and every officer of the company who is in default shall be punishable with a fine which may extend to Rs.500 as per section 224(4).

Appointment of Auditor by Special Resolution.

In 1974, Companies Act 1974 was amended by adding sub section A to section 224. After that, in some cases, the appointment of auditors or auditor requires special resolution. That is in case of a company, in which not less than 25% of the subscribed share capital is singly or jointly held by.

a. A public financial institution or a government company or the central government or any state government or
b. Any financial or other institution established by any provincial or state Act in which a state government holds not less than 51% of the subscribed share capital or
c. A nationalized bank or an insurance company carrying on general insurance business.

In the above mentioned circumstances, the appointment of an auditor shall me made by passing a special resolution (that is 75% or more of the members present should agree for the resolution). If not, it shall be deemed that the appointment has not been made and the centralgovernment will get the right under section 224(3) of the Companies Act to make an appointment.

Compulsory Reappointment.

Section 619 of the Companies Act specifies that in the case of government companies, the appointment or reappointment of an auditor by the central government can be made only on the advice of the comptroller and Auditor General of India.

In other cases, that is, whether auditors are appointed by the board of directors in the annual general meeting or by the central government, the retiring auditors are compulsorily reappointed, unless

1. He is not qualified for reappointment.
2. He has given a notice in writing to the company of his unwillingness, to be reappointed
3. Where a notice has been given or an intended resolution to appoint some other person in the place of the retiring auditor and by reason of death, in capacity or disqualification of that person or of all the persons as the case may be, the resolution cannot be proceeded with or
4. A resolution has been passed at that meeting, appointing somebody instead of providing expressly that he shall not be reappointed. This is as per section 224(2) of the Companies Act.

Ceiling on Number of Audits

In 1974, a group of young charted accountant, academicians and other sections of the public argued that the opportunities of professional practice are concentrated in the hands of a few well established and leading chartered accountants of the country. They demanded this monopoly be liquidated in the general interest of the profession thereby providing an opportunity to young chartered accountants also to earn their living. Therefore, the companies act was amended in 1974, by introducing section 224 (1-B). This came into effect from February 01, 1975 to ensure a more equitable distribution of audit work among all the practicing chartered accountants and to avoid the concentration of audit work in few leading firms of chartered accountants.

Therefore, according to section 224(1-B) of the Companies Act, no individual and no partner of the firm of auditors shall hold office as auditors of more than 20 companies of which not more than 10 be companies with paid up share capital of Rs.25 lakhs or more.

Filling of Casual Vacancies [Section 224(6)]

1. A vacancy caused by the resignation of an auditor shall only be filled by the members in the annual general meeting.
2. If a casual arises for any other reason (that is, death, insanity or insolvency) it can only be filled by the board of directors.
3. An auditor appointed to fill up the casual vacancy shall hold office until the conclusion of the next annual general meeting of the company.

Qualification of Auditor.

According to Section 226(1) and 226(2) of the Companies Act, the prescribed qualifications of an auditor are as follows:

1. A person who is a chartered accountant within the meaning of the Chartered Accountant's Act 1949.(Section 26(1)]
2. A person who holds a certificate under the Restriction Auditors Certificate Rules 1956 is also qualified to act as an auditor of a company. Such persons are also known as certified auditors and are always subject to rules made in this behalf by the central government [section 226(2)]

The central government in empowered to frame rules relating to granting renewals, suspension or cancellation of such certificates.

Disqualification of a Company Auditor.

According to section 226(3) of the Companies Act, the following persons shall not be appointed as auditors of a company.

1. A body corporate.
2. An officer or an employee of the company.
3. A person who is a partner in the business.
4. A person who is indebted to the company for an amount exceeding more than Rs.1000/- or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs.1000/-.
5. A director or a member of a private company

Besides the above disqualification, certain additional disqualifications as also prescribed by the companies (Amendment) Bill 2003.

These are:

1. An auditor who has any direct financial interest in the company.
2. An auditor who received only loan or guarantee from or on behalf of the company.
3. An auditor who has any business relationship in the company.
4. An auditor who has been employed in the company
5. An auditor whose relatives are in the employment of the company. If an auditor, after his appointment becomes a subject of any of the above mentioned disqualifications, he shall be deemed to have vacated his office forthwith.

Removal of an Auditor.

1. The first auditors appointed by the directors prior to the first annual general meeting of the company may be removed by the members in the annual general meeting even if there tenure of office has not expired.

The general meeting may in their place, appoint any other person, notice for whose nomination has been given by any member not less than 14days before the date of the meeting.

2. In any other case, the auditor may be removed from office before the expiry of his term by the company in the annual general meeting after obtaining the previous approval of the central government in this behalf. This provision is as per section 224(7) of the Companies Act.
3. But section 225 of the Companies Act makes special provisions in this respect, in order to safeguard the interests of an independent auditor against unfair and unjust removal at the hands of an unscrupulous management.

The procedure so laid down is as follows:

a. Special notice of intention to make such resolutions to remove the existing auditor must be given to the company by the shareholder not less than 14days before the annual general meeting.
b. On receipt of such a notice, the company must forthwith send a copy to the retiring auditor.
c. The retiring auditor has the right to send a representation to the company which he can ask the company to send to the shareholders.
d. If a copy of the representation is not sent to the members, either because it was received too late to be thus sent, or because of the default of the company, the auditor may insist that the representation shall be read out in the meeting.
e. The auditor, who is proposed to be removed, has the right to attend the general meeting where his removal is to be discussed. He also has the right to speak at such a meeting.
f. As a matter of professional conduct, the auditor so appointed in place o another should communicate with the retiring auditor in writing before accepting the appointment. If he does not do that, he may be held liable for disciplinary action as per the regulations of the Institute of Chartered Accountants of India.

Remuneration of an Auditor.

1. The general rule is that the appointing authority is authorized to fix the remuneration f an auditor as per Section 224(8)
2. In the case of a new company where the auditors are appointed by the board of directors, the remuneration will be fixed by the board of directors.
3. Similarly, if an auditor is appointed to fill a casual vacancy the remuneration will be fixed by the board of directors.
4. When an auditor is appointed by the Central Government the remuneration will also be fixed by the Central Government.
5. If the auditor's appointed at the annual general meeting, the remuneration is also fixed at the annual general meeting.
6. Remuneration includes the sum paid by the company in respect of the auditor's expenses.
7. Where the auditor is reappointed in the next annual general meeting, the amount fixed in the previous year is considered for the currency year also, if nothing more is specifically provided as remuneration in the current annual general meeting.
8. A part from the routine audit work, if a chartered accountant is entrusted with the work of taxation, writing up of the account books and other professional services then the auditors and the board of directors can fix up the remuneration mutually for the additional work. Moreover, the sanction of the share holders is not needed for the same.
9. Any remuneration paid for services other than routine audit work should be explained in the Profit and Loss account separately as under:
   i. Remuneration as an Auditor of the company.
   ii. In the capacity of an adviser in respect of:
      a. Taxation representation.
      b. Company Law matters
      c. Management Services.
      d. Internal Auditing
      e. Other professional services and
      f. For travelling and out of pocket expenses.

Rights of Company Auditors.

According to Section 227(7) of the Companies Act, a company auditor has the following rights.

1. **Right of Access to Books of Accounts:**

As per Section 227(1) of the Companies Act every auditor of the company has the right to access at all times to the books of accounts and vouchers of the company, whether kept at the head office of the company or elsewhere.

Under section 209(1) (d), a company auditor has the right to examine the cost records also which are required to be maintained by certain companies relating to production sales, stores etc.

2. **Right to Obtain Information and Explanations**:

An auditor can call for any information or explanation from different officers of the company which he may think necessary for the performance of his duties.

Under section 221, apart from the auditor's right to obtain information and explanation it is the duty of every officer of the company to furnish without delay the information to the company auditor.

The power is so wide; the decision as to what information and explanation is left entirely to the discretion of the auditor. If the directors or officers of the company refuse to supply some information on the ground that in their opinion it is not necessary to furnish it, then the auditor has the right to mention that in his audit report.

3. **Right to Receive Notices and Other Communication Relating to General Meetings and to attend them.**

According to section 231, of the companies act an auditor of a company has the right to receive notices and other communications relating to the general meetings in the same way as that of the members of the company.

Similarly an auditor also has the right to attend any annual general meeting and also to be heard at those meetings which he attends and which concerns him as an auditor.

The auditor also has the right to make a statement or explanation with regard to the accounts he has audited. But he auditor is not expected to answer questions in the general meeting.

4. **Right to Visit Branches.**

According to section 228 of the companies act the auditor of the company has the right to visit the branch office or offices of the company.

He can also audit such accounts of eh offices of the company provided that there is not qualified auditor to audit the accounts of the branch office or offices of the company, in such cases, the auditor has the right to access at all times to the books of accounts and vouchers that the company maintains at branch office or offices.

Moreover section 226 of the companies act provides that in case of the company gets the branch accounts audited by some of the local auditors, even the auditor has access at all times, to the books, accounts an vouchers of the company and he can also visit the branches, if he feels necessary.

5. Right to Correct Any Wrong Statement.

The company auditor is required to make a report to the members of the company on the accounts examined by him of the final accounts and the related documents which are laid down before the company in the general meeting.

Similarly, the auditor can advice the directors to amend their system of maintaining accounts. If the suggestions are not carried out, he has the right to refer the matter to the members and also to report that in the audit report.

6. Right to sign the Audit Report

As per section 229 of the companies act only the person appointed as auditor of the company or where a firm is so appointed, only a partner in the firm practicing in India, may sign the audit report or authenticate any other document of the company required by law to be signed.

7. Right to Being Indemnified.

Under Section 633 of the Companies Act, an auditor is considered to be an officer of the company and he has the right to be indemnified out of the assets of the company against any liability incurred by him in defending himself against any civil and criminal proceedings by the company if it is proved that the auditor has acted honestly or the judgment is delivered in his favour.

8. Right to seek Legal and Technical Advice.

The company auditor has the full right to seek the opinion of the experts and to take their legal and technical advice so as to discharge his duties efficiently.

9. Right to Receive Remuneration.

As per Section 224(8) of the Companies Act, the company auditor has the right to receive remuneration provided he has completed the work which he has undertaken to do so.

Duties of Company Auditor.

The various duties of the company auditor are as follows:

1. **To make special enquiries and investigation:** in connection with the following matters under section 227(1-A) of the Companies Amendment Act 1965.

A company auditor shall enquire:

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

b. Whether the transactions which are not supported by any fact or evidence, though recorded in the books are not prejudicial to the interests of the company.
c. Whether personal expenses have been charged to the revenue account.
d. Whether it has stated in the books of accounts of the company that any shares have been allotted for cash and whether cash has actually been received in respect of such allotment, and if no cash has actually been received, whether the position as stated in the account books and the Balance Sheet is correct and regular.

2. Duty to make a Report to the Shareholders.

Under Section 227(2,3,4&5) of the Companies Act, the auditor shall report to the share holders about the accounts examined by him. The report so mentioned shall contain the following.

a. Whether in his opinion, the Profit and Loss Account referred to in his report exhibits a true and fair view of the profit or loss.
b. Whether in his opinion, the Balance Sheet referred to in his report is properly drawn up, so as to exhibit a true and fair view of the state of affairs of the business according to the best of his information and explanations given to him and as shown by the books of accounts.
c. Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
d. Whether in his opinion, proper books of accounts as required by law have been kept by the company and proper returns adequate for the purpose of his audit have been received from branches he visited or not.
e. Whether report on branch accounts audited under section 28 by a person other than the company's auditor has been forwarded to him as required by clause (c) sub section (3) of that section and how he had dealt with the same in preparing the auditor's report.
f. Whether the company's Balance Sheet and Profit and Loss Accounts dealt with by the report are in agreement with the books of accounts and returns.

   If the answer to any of the above mentioned questions is in the negative, the auditor should submit his report accordingly.

3. Duty to comply with the Directives of the Central Government.

It is the duty of the auditor to comply with the various directives issued to the auditor of the joint stock companies from time to time to give specific reports on the financial accounts of the companies.

For example in 1975 it was made compulsory for some of the specified companies which are engaged in any of the below mentioned activities to conduct cost audit, that is, those companies engaged in

a. Manufacturing, mining or processing.
b. Supplying and rendering services
c. Trading
d. Business of financial investments, chit funds, nidhi or mutual benefit societies.

4. **Duty to sign the Audit Report.**

As per section 229 of the companies act 1956, it is the statutory duty of the company auditor to sign the report prepared by him. Only a partner practicing in a firm in India can sign the audit report for and on behalf of a partnership firm practicing as chartered accountants.

5. **Duty to give a Statement in the Prospectus.**

As per section 56(1) of the companies act, the prospectus issued by an existing company shall contain a report from the auditor of the company regarding

   a. Profits and losses during the previous year.
   b. Assets and liabilities of the company and its subsidiaries and
   c. The rate of dividend paid by the company in respect of each class of shares in the company for each of the five financial years preceding the issue of prospectus.

   So it is the statutory duty of the company auditor to submit his report containing the above mentioned points.

6. **Duty to Certify the Statutory Report**.

According to section 165(4) the auditor of the company has to certify the statutory report regarding the shares allotted by the company, the cash received in respect of shares, and the receipts and payments of the company. The statutory report should also be certified as correct by two directors, one of whom shall be managing director.

Every company shall within a period of not less than one month and not more than 6months from the date which the company is entitled to commence business has to conduct a general meeting of the members of the company which is known as the statutory meeting.

7. **Duty to make a declaration of Solvency, if the company Goes into Voluntary Winding up**

   When a company goes into voluntary winding up, then a declaration of solvency is to be made by the directors of the company. Under section 488(1) of the Companies Act, this declaration is to be accompanied by the report of the auditor of the company under the section 488(2) of the companies act. So it is the duty of the auditor to make such reports.

8. **Duty to produce information and to assist the investigation, if any investigation is conducted regarding the working of the company.**

Under section 240(6) (b), it is the duty of an auditor to preserve and produce to the inspector or any other person authorized by him in this behalf with the previous approval of the central government, all books and papers of or relating to the company or as the case my be, of relating to the other body corporate which are in their custody or power and other wise to give to the inspector all the assistance in connection with the investigation which they are reasonably able to give.

9. **Duty to perform the contract**

It is the duty of the auditor to discharge the duties according to the terms of contract between the auditor and the party who has appointed him. It is to be remembered that the scope of statutory duties of a company auditor cannot in any way be curtailed. But on the other hand, the scope of duties of the auditor can be enlarged by passing a resolution at the annual general meeting making a provision in the Articles of Association of the company. If so, it is the duty of the auditor to perform the additional work.

10. **Duty to care and caution.**

The auditor is appointed in the capacity of an expert, therefore, he must act honestly and exercises cure care and caution in the performance of his duties. The auditor can never give ignorance as an excuse for defense. So the auditor must prove that in the course of his audit work, he has employed skills that would reasonably be applied by any other auditor.

Special Audit of Companies.

As per section 233 A of the companies act, the central government has the power to direct special audit in the following cases for a specified period. That is, when the central government is of the opinion.

1. That the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices or
2. That any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains or
3. That the financial position of any company is such as to endanger its solvency.

Auditor appointed under this section under the above mentioned circumstances are known as Special Auditors. Special audit is entirely different from investigation as per section 235. For example: the audit firm Lovelock and Lewies was asked by the central government to conduct a special audit for ITC company for which they audited the accounts and to submit a report when the ITC scam was reported.

Powers and Duties.

The powers and duties of the special auditors are identical to the rights and duties of a company auditor as specified in section 227.

Remuneration.

The remuneration of the first auditor is fixed by the Board of Directors, if he is appointed by the Board of Directors.

The remuneration of every subsequent auditor, who is appointed by the company, is fixed by the company in the general meeting.

Where a subsequent auditor is appointed by the Central government on the failure of the company to appoint the auditor, his remuneration will be fixed by the Central Government. The liabilities of a Company Auditor.

1. **Civil Liability of an Auditor for negligence**.

The liability of an auditor to pay damages are known as Civil Liabilities. Every auditor in the performance of his job is expected to exercise reasonable care and skill as per the circumstances, because the shareholders of the company appoint the auditor as their agent and therefore, he must exercise reasonable degree of skill and care in the performance of his duties. If not, the auditor will have to face the consequences.

Therefore, we can conclude that an auditor can be held liable for negligence of his duty if it is proved that

a. There has been a negligence in the performance of his duty and it may be due to the absence of requisite professional skills or failure to exercise it.
b. There happens to be a loss or damage as a result of his negligence and
c. The loss was suffered by his client.

However, the court has the power to grant relief, wholly or partly to an auditor. We can also present the situation as given below.

1. Loss without negligence and
2. Negligence without loss.

a. Liability of the Auditor for Mis-statements in the Prospectus.

As per section 65 of the companies act 1956, an auditor may be held liable for damages suffered by those persons who subscribed to the shares or debentures of a company or debentures of a company proposing in the faith of the prospectus, which included auditor’s report containing some untrue statements or facts. The auditor and every person who has authorized the issue of the prospectus shall be punishable with imprisonment for a term which may extent of 2years or with fine, which may extend to Rs. 5000 or with both, for the damages sustained directly resulted from those untrue statements. For the purpose of this clause, even those statements shall be taken to be untrue which are misleading in form and the context in which they are included.

But the auditor can escape from his liability if he is able to prove:

i. That he withdrew his consent in writing before the delivery of the copy of the prospectus for registration.
ii. That he withdrew his consent in writing from such a prospectus on coming to know of the untrue statement by giving a reasonable public notice before the allotment of shares.
iii. That he was competent to make the statement and that he has reasonable grounds to believe up to the time of allotment of the shares, that the statement was true or he relied upon the opinion of an expert whose name he has quoted in his certificate.

b. Civil Liability of an Auditor for Misfeasance.

By misfeasance we mean breach of trust or duty imposed by law for negligence in the performance of duties, which results in some loss or damage to the company. If an auditor does something wrong in the performance of his duties resulting in financial loss to the company he is guilty of misfeasance.

As per section 543 of the companies act. The liquidator can bring the suit in the name of the company against the auditor, that is "in the course o winding up of a company, it appears that any officer, including eh auditor or any other person associated with the promotion or the management of the company has misapplied or retained wrongfully, any property of the company or is guilty of breach of duty, he can be held liable for the damages caused to the company"

But section 633 grants relief to directors, officers, and auditors of the company against liability in respect of negligence, default, breach of duty, misfeasance or breach of trust. But for getting any relief there under, it must be proved by the person concerned.

a. That he has acted honestly.
b. That he has acted reasonably and
c. That having regard to all the circumstances of the case, he ought fairly to be excused.

2. Criminal Liabilities of a Company Auditor.

The auditor of a company becomes criminally liable for various offences during the course of his audit. Criminal liability of an auditor will arise when he is found to be guilty of willful non compliance under the provisions of law. Under the criminal liabilities, he may be imprisoned, fined or punished with both as per the companies act, income tax act, and the Indian Penal Code. Criminal liability of an auditor arises from errors in the performance of audit.

The auditor can be held criminally liable under:

1. The Companies Act.
2. The Income Tax Act.
3. The Chartered Accountant Act

a) **Criminal Liabilities under the Companies Act.**

i. **Section 233**

If the auditor does not comply with the requirement of section 227 and 229 as to make of his report, of signing or authenticating any document and if such default on his part is willful, he shall be punishable with fine which may extend to Rs. 1000

ii. **Section 240**

If the auditor of a company doesn't give the required assistance to an inspector appointed by the central government to investigate into the affairs of the company, the auditor of the

company is punishable with imprisonment up to 6months or fine up to Rs.2000 or both. For persistent default a further fine at Rs. 200 per day may also be charged.

iii. **Section 242**

When on the basis of the report submitted by an inspector, the central government takes action and prosecutes any person connected with the affairs of the company is required to assist the prosecution. If he does not do so, he is guilty of contempt of court and punishable to the extent of imprisonment for 6months of fine of Rs 500 or both.

iv. **Section 477**

When the company is wound up, the auditor is subjected to a private examination by the court and is also liable to return to the court any books and documents of the company in his possession. If he does not appear before the court he can be arrested.

v. **Section 478**

On an application from On an application from the official liquidator, the auditor of a company is liquidation can be publicly examined in high court. Notes of the examination shall be taken down in writing and that should be signed by the auditor which may thereafter be used as evidence against him in any other civil or criminal proceedings.

vi. **Section 539**

If an auditor destroys, mutilates, alters, falsified or secretes or is a partly to the destruction mutilation alteration or falsification or secreting of any books papers or securities or makes or is a party to the making of any false or fraudulent entry in any register books of accounts or documents belonging to the company, he shall be punishable with imprisonment for a term which may extend to 7years and also be fined.

vii. **Section 545**

The court may direct the liquidator of a company in winding up to prosecute the auditor if he is found guilty of any criminal offence in relation to the company.

viii. **Section 628**

An auditor is also liable to criminal prosecution, if he in any return, certificate, balance sheet, prospectus, statement or any other document required by or for the purpose of the act makes a statement.

1. Which is false in any material, particularly knowing it to be false.
2. Which omits any material fact knowing it to be material.

The punishment on conviction is imprisonment for a term which may extend up to 2years and shall also be fined.

ix. **Section 629**

If any person including an auditor intentionally gives false evidence upon nay examination up on oath or solemn affirmation authorized under the act or in any affidavit, deposition or

solemn affirmation in or abut he winding up of any company under he act, he shall be punishable with imprisonment for a term which may extend to seven years and shall be liable to fine also.

Conclusion.

If the Articles of Association or any special agreement between the company auditor and the company contains any provision which exempts the auditor from any of the above legal liabilities for negligence, defaults, misfeasance, breach of trust, breach of duty etc it shall be considered void. However, according to section 633 the company can indemnify such officers including he company auditor for any of the losses suffered by him.

b) Criminal Liabilities under the Income Tax Act.

A qualified chartered accountant or the auditor of the company can act as authorized representative and may attend the Income Tax Authority or the Appellate Tribunal in connection with the proceedings under the Income Tax Act.

a. **Section 288**

This section provides that if a person who is convicted of an offence in connection with taxation proceedings will be disqualified from representing an assesse. The commissioner of Income Tax has been empowered to determine the period of such disqualification.

If the council of the Institute of Chartered Accountants of India finds that any chartered accountant is guilty in his professional misconduct, default in taxation etc. the institute can also declare him disqualified for certain specified period.

b. **Section 277**

As per this section 2years imprisonment may be imposed on the auditor if he auditor submits knowingly any false statements in the form of accounts for the preparation of income tax returns.

c. **Section 278**

As per this section any person who induces in any manner any other person to make and deliver to the income tax authorities, some false statements or declaration relating to chargeable income tax, highlighting the fundamental principle of criminal law that any person who aids, counsels or procures the commission of an offence is liable to be punishable with rigorous imprisonment for a minimum period of 3months and maximum of 3years with fine. In case the amount of tax to be evaded is in excess of Rs. 100000 the minimum and maximum period of rigorous imprisonment will be 6months and 7 years maximum with fine.

c) Criminal Liabilities of an Auditor under the Chartered Accountants Act 1949.

1. If a person not being a chartered accountant within the meaning of chartered accountants act of 1949 acts as an auditor of a company and signs any documents, then he may be held liable for criminal prosecution under section 29 of the chartered accountants act 1949. The punishment for this is fine which may extend to Rs.1000 on first conviction and with imprisonment extending to 6months or fine amounting to Rs.5000 or both on any subsequent conviction.
2. According to Part III of the first schedule of Chartered Accountants Act 1949 a member of the institute whether in practice r not, shall be deemed to be guilty of professional misconduct if he:

a. Includes in any statement return or form to be submitted to the council any particulars knowing them to be false.
b. Not being a fellow styles himself as fellow
c. Does not supply he information called for or does not comply with the requirements asked for by the council or any of its committees.

3. **Auditors Liabilities to Third Parties.**

Besides the client, the creditors, bankers, prospective share holders, tax authorities etc depend fully upon the final accounts certified by the auditor and do different dealings with the company.

The liability of an auditor towards third parties can be discussed under 2circumstances.

a. For Frauds.

If in case there is any fraud on the part of the company's auditor, the third parties can however hold him liable. This 3rd party can sue the auditor if the report of the auditor is of such a nature, as amounts to fraud, even in there is no contractual obligation between the auditor and the 3rd party.

It was decided in the case of Derry Vs Peek (1882) that the auditor can be held liable to 3rd partied only when the following facts are proved against him.

i. That the statement or balance sheet signed by the auditor was materially untrue
ii. That the statement or the Balance Sheet was made an intention that a 3rd party should act on it.
iii. That the auditor knew that the statement of balance sheet was untrue.
iv. That the 3rd party acted upon such a statement and consequently suffered a loss.

b. That the auditor gave his consent for the inclusion of such a statement in the prospectus.For Negligence.

An auditor in general is not liable to 3rd parties for negligence of duty as no contractual obligation exists between the auditor and the 3rd party. As he is not appointed by them, he owes no duty towards them and hence there is no question of any type of liability.

PART A

1. Who can be appointed as an auditor?
2. How a casual vacancy is for an auditor is filled up?
3. State the steps to be taken to remove the first auditor of a company.
4. Who cannot become an Auditor of a company?
5. Who are first auditors and how are they appointed?
6. Give a note on appointment of auditors by central Government.
7. How can be appointed an auditor of a Government Company?
8. State the procedure for removal of an auditor after the expiry of his term?
9. What are the different types of audit report?
10. What are the powers of a company auditor?

PART B

1. Explain in detail about the appointment of auditors in a company?
2. Give a note on appointment of auditors by shareholders?
3. Explain when an auditor is appointed by special resolution?
4. Explain the ceiling on number of audits by a chartered accountant?
5. Discuss the power and duties of a company auditor?
6. Discuss the various duties and liabilities of an auditor as peer the companies Act?
7. Explain about the qualifications and disqualifications of an Auditor?
8. Discuss about the Retirement and Reappointment of Auditor in a company?
9. Discuss about the Civil and Criminal liabilities of a company auditor?
10. Discuss about (a) Annual General Meeting (b) Special audit of companies (c) Filling of casual vacancies.

REFERENCE:

1.Dinkar Pagare,Principles & Practice Of Auditing,Sultan Chand & Sons,Edition 2019

2.Tandon B. N.Handbook of Practical Auditing,Sultan Chand & Sons,Edition 2019

3.R. G. Saxena,Principles & Practice Of Auditing,Himalaya Publishing House

SCHOOL OF MANAGEMENT STUDIES

UNIT V - PRACTICAL AUDITING – SBAA3001

FINANCIAL STATEMENT AUDIT: Special Considerations in Company Audit - Preservation of Financial Statements - Audit of Share Capital - Audit of Dividends and Debentures.

A financial statement audit is the examination of an entity's financial statements and accompanying disclosures by an independent auditor. The result of this examination is a report by the auditor, attesting to the fairness of presentation of the financial statements and related disclosures.

General Considerations in Company Audit

These have to be determined on a consideration of :

(a) objectives of audit;

(b) various provisions in the Companies Act,1956, especially those concerning accounts and audit; and

(c) the scope of the report that the auditor of a company is required to make in pursuance of the provisions

The objectives of an audit are :

(i) Verification of statements of account so as to express an opinion;

(ii) Detection of errors and frauds; and

(iii) Prevention of occurrence of errors and frauds.

Detection and prevention of frauds and errors were originally regarded as the main objectives

Special requirements of a company audit

(i) Verification of the constitution and powers- A company can function within the limits prescribed by the documents on the basis of which it has been registered. It raises its capital from the public on certain conditions, specified in the Prospectus. Before commencing business, to purchase a property or to have subscription to its capital underwritten on this account, it is essential that the auditor, prior to starting the audit of a company, shall examine:

(a) The Memorandum of Association.

(b) The Articles of Association.

(c) Contracts entered into with vendors and other persons relating to purchase of property, payment of commission, etc.

(ii) Matters which require sanction of the Central Government –

(a) Appointment of Directors

(b) Disqualifications of Directors

(c) Conduct of Board Meeting

(d) General powers of Board

(e) Powers which the Board must exercise only at a meeting

(f) Restriction on powers of the Board regarding disposal of the undertaking or part of it etc.

(g) Prohibitions and restrictions regarding political contributions

(h) Power of Board and other persons to make contributions to the National Defence Fund, etc.

(i) Restriction on advancing loans to Directors, etc.

(j) Restriction on a Director or his relative, a firm in which a director or relative is a partner; or any other partner of the firm or a private company of which such a director is a member or director to enter into a contract of sale or purchase of goods except with the sanction of the Board of Directors

(k) Restriction on an interested director in participating in or voting at Board's proceedings

(l) Disclosure of interest by directors

(m) Register of contracts, Companies or firms in which directors are inspected

(n) Remuneration of directors

(o) Restraint on a director's holding offices or places of profit

(p) Restraint on payment of compensation for loss of office to a director

(q) Restriction on loans, etc., to companies under the same management

(r) Regulation of inter-corporate loans and investments

(iii) Special considerations involved in the examination of certain documents

(a)Memorandum of Association- It is a charter containing particulars of business activities that the company can undertake and the powers it can exercise in regard thereto.

b) Articles of Association- These are rules and regulations for the internal management of the company; and they define the rights of different classes of shareholders, conditions under which calls can be made, the maximum and minimum number of directors the company can have, their qualifications, disqualifications and removal, etc.

c) Prospectus- It is a formal document which a public company must issue before it makes the allotment of shares.

Financial Statement

1. **Meaning of Financial Statement**

In relation to a company, **"financial statement"** means the **collective records** of the Balance Sheet, statement of Profit and Loss, Cash Flow Statement, Statement of Changes in Equity (if applicable) and an Explanatory Notes annexed to the Financial Statements. The statements have to be prepared at the end of the financial year and may be kept in electronic form provided they are complete and unaltered. Further, all such statements and books have to be preserved at the companies registered office or any other place that the Board of Directors may decide.

(It is important to note that, cash flow statements are not mandatory for small companies, one person companies and dormant companies).

2. **Requirements of Financial Statement**

The Financial Statements shall abide with the **accounting standards** and be in the form as prescribed in **Schedule III** and shall give a **true and fair view** of the financial condition of the company. The financial statements shall be disclosed in the annual general meeting.

In case of a holding company, it shall additionally prepare a **Consolidated Financial Statement** of the Company along with that of its subsidiaries, associates and joint ventures and disclose it at the annual general meeting. The consolidated financial statements have to be prepared in accordance with Schedule III of the Companies Act 2013 which is in line with the revised Schedule IV.

A company is required to attach with its Financial Statements, a separate form **AOC-1** in order to file it with the Registrar of Companies.

3. **Board Approval**

The financial statements including the consolidated financial statement has to be **approved** and signed as prescribed, by the Board of Directors. It can be signed either by the authorized chairperson of the Board or by at least 2 directors and the appointed company secretary. The Board's Report and Auditor's Report are to be attached with the Financial Statement before it is issued.

4. **Re-opening of Accounts**

The Companies Act 2013 provides for the re-opening or re-casting of the books of accounts pursuant to an order of the Court or Tribunal on an application made by the Central Government, Statutory Authority or any person concerned if, it was found that the earlier accounts were prepared in a fraudulent manner due to the mismanagement of the affairs of the company.

Further, if it appears that the financial statements or board reports are not in compliance with the provisions of this Act, the Company may revise such statement or report with the approval of the Tribunal. Such revised or re-casted reports or statements shall be final.

5. **Revision of Accounts and Reports**

The Board may pass a resolution to revise the financial statements or books of accounts if, they believe that the statements **do not comply** with the requirements of **Section 129** or **Section 134**. Such revision can be done for any of the 3 preceding financial years, only after obtaining **prior approval of the Tribunal.**

The reason for the revision along with the revised statements have to be filed in the Board Report and needs the approval of the board at the annual general meeting. It requires an auditor's report as well. In the event there is a different auditor, then the revised financial statements have to be accompanied by a consent letter from the auditor who's work sought to be revised.

Such revised financial reports have to be filed with the Registrar of Companies along with a copy, if any, of the Tribunal.

6. **The National Financial Reporting Authority**

The Companies Act 2013 provides that, the Central Government may, by notification, constitute the National Financial Reporting Authority with the predominant objective of **advising** on Accounting Standards (AS) and Auditing Standards (SA) and to **monitor, enforce,** and **oversee** the compliance and quality of service of associated professionals.

The National Financial Reporting Authority shall have the power to investigate companies or professionals in the matters of misconduct, order discovery production of books of accounts, summon or enforce attendance, order inspection of books, registers and documents, pass orders. The decisions of the National Financial Reporting Authority are appealable to the Appellate Authority.

7. **Accounting Standards**

The Central Government may, after consultations with the National Financial Reporting Authority, may prescribe the Accounting Standards to be adopted by the companies in completion of their financial statements.

The following Accounting Standards (AS) are applicable to all companies. The **AS-1** for disclosure of accounting policies; the **AS-2** for valuation of inventory; the **AS-3** for cash flow; the **AS-4** for contingencies and events occurring after balance sheet date; **AS-5** for net profit or loss for the period; **AS-6** for depreciation; the **AS-7** for construction contracts; the **AS-9** for revenue recognition; the **AS-10** for accounting of fixed assets; the **AS-11** for the effects of change in forex rates; the **AS-12** for government grants; the **AS-13** for investments; the **AS-14** for amalgamations; the **AS-16** for borrowing costs; the **AS-17** for segment reporting; the **AS-18** for related party transactions; the **AS-22** for income taxes; the **AS-24** for discontinuing operations and the **AS-26** for intangible assets.

In case a company has to prepare consolidated financial statements, the following accounting standards would have to be followed; the **AS-21** for consolidated financial statements, the **AS-23** for investment in associate companies; the **AS-27** for reporting of interest in joint ventures and the **AS-25** for interim financial reporting.

8. **Board Report & Directors Responsibility Statement**

The **Board Report** shall contain the extract of the Annual Return (MGT-9) as prescribed, the number of board meetings held, the directors responsibility statement, a declaration by Independent Directors regarding their appointment, the company's policy on the Directors Appointment and Remuneration, explanations by the Board with regard to every reservation or adverse remark made by the Auditor in his Report or the Company Secretary in his Report, particulars of loans and guarantees under section 186, particulars of related party transactions (AOC-2), the state of company's affairs, statement of material changes affecting the company's financial position, state with regard to developing and implementing risk management policy and corporate social responsibility policy.

The **Directors Responsibility Statement** shall contain the details of the accounting standards followed with explanations for material departures, prudent judgments made as to give a true and fair view of the state of affairs of the company, measures taken to maintain adequate accounting records and safeguard assets, and measures taken to ensure compliance with all applicable laws.

9. **Right of Members**

All members have the rights to receive the copies of financial statements and every report required to annexed with the financial statements at least 21 days before the date of the annual general meeting.

10. **Filing of Financial Statements**

The financial statements along with prescribed reports have to be filed with the **Registrar of Companies** within 30 days of the Annual General Meeting.

Preservation of Books of Accounts

The company has to preserve its books of account of 8 financial years immediately preceding a financial year and in case the company had been in existence for less than 8 years, the records of all the preceding years shall be preserved.

Penalty for Default

As per Section 128 of the Companies Act, the officer who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than Rs.50,000.00 but which may extend to Rs.5,00,000 or with both.

The officer who is in default means the Managing Director, the whole-time director in charge of finance, the Chief Financial Officer or any other person of a company charged by the Board with the duty of complying with the provisions of this section, contravenes such provisions, such managing director, whole-time director in charge of finance, Chief Financial officer or such other person of the company)

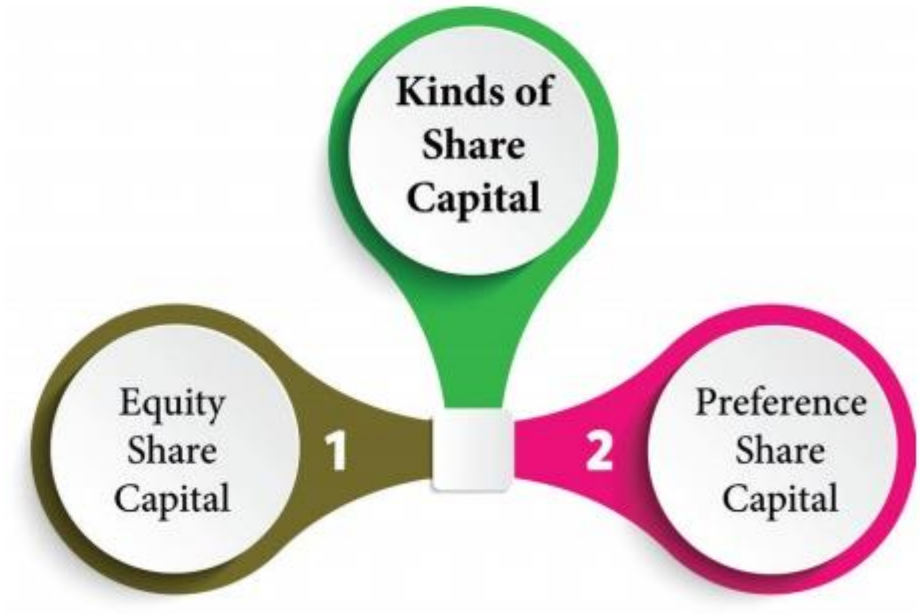
Audit of Share Capital

Meaning of Share Capital

Share capital means capital raised by the company by issue of shares. This issue of share capital should be audited to verify the compliance of requirements and provisions of Companies Act.A company may meet its fund requirements either through raising share capital or through borrowings. The company does a proper financial analysis before taking such a decision. The funds raised through issue of shares are termed as share capital.

Kinds of Share Capital

The share capital of the company is of two kinds, namely, Equity share capital and Preference share capital.



1. Equity Share Capital

Equity share capital means all share capital, which is not preference share capital and called as the ordinary share capital of the company.

2. Preference Share Capital

Preference share capital means that part of the issued share capital of the company which either carries or would carry a preferential right with respect to payment of dividend and a preferential right of repayment in case of winding up or repayment of capital. Apart from these two preferential rights, preference shares can be of participating or non-participating type depending upon their right to participate in dividend payment with capital.

1. Equity Share Capital

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Preference share capital means that part of the issued share capital of the company which either carries or would carry a preferential right with respect to payment of dividend and a preferential right of repayment in case of winding up or repayment of capital. Apart from these two preferential rights, preference shares can be of participating or non-participating type depending upon their right to participate in dividend payment with capital.

Audit of Share Capital of a New Company (or) Fresh Issue of Shares

The first function of the Company after incorporation was to raise funds. The funds can be raised either by issue of securities or by loan or borrowings. Section 23 of Companies Act, 2013 makes a distinction between public and private company as far as raising funds is concerned.

Section 23 of Companies act, 2013 provides that:

Public company my raise a fund or issue securities, by:

1. Issue of prospectus to public either by Initial Public Offering **(IPO) or** Follow on Public Offer **(FPO)**, or
2. Private placement, or
3. Right issue
4. Bonus issue.

Private companies may raise fund or issue securities, by:

1. Right issue
2. Bonus issue
3. Private placement.

Meaning of Fresh Issue of Shares

Fresh issue of shares refers to the shares issued through Initial Public Offering (IPO).

It means when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for first time to public. Unlisted company is one whose security is not listed on any of the recognized stock exchange.

The underwriter serves as the intermediary between the company seeking to issue shares in an initial public offering (IPO) and investors. The underwriter helps the company to prepare for the IPO, considering issues such as the amount of money sought to be raised, the type of securities to be issued, and the agreement between the underwriter and the company. Syndicate Underwriting is one in which, two or more agencies or underwriters jointly underwrite an issue of securities. Such an arrangement is entered into when the total issue is beyond the resources of one underwriter or when he does not want to block up large amount of funds in one issue. Sub-Underwriting is one in which an underwriter gets a part of the issue further underwritten by another agency. This is done to diffuse the risk involved in underwriting. The name of every under-writer is mentioned in the prospectus along with the amount of securities underwritten by him. Firm Underwriting is one in which the underwriters apply for a block of securities. Under it, the underwriters agree to take up and pay for this block of securities as ordinary subscribers in addition to their commitment as underwriters.

This Initial Public Offering can be made through the fixed price method, book-building method or a combination of both. Under fixed price method, the investors know the price at which the securities are offered and allotted in advance. Book Building is a process used by companies to raise raising capital through Public Offerings-both Initial Public Offers (IPOs) and Follow-on Public Offers (FPOs) to aid price and demand discovery.

Private Placement is issuing share capital to a select group of people, including or not the existing shareholders, like friends, family members, Angel investors, Venture Capitalists etc.

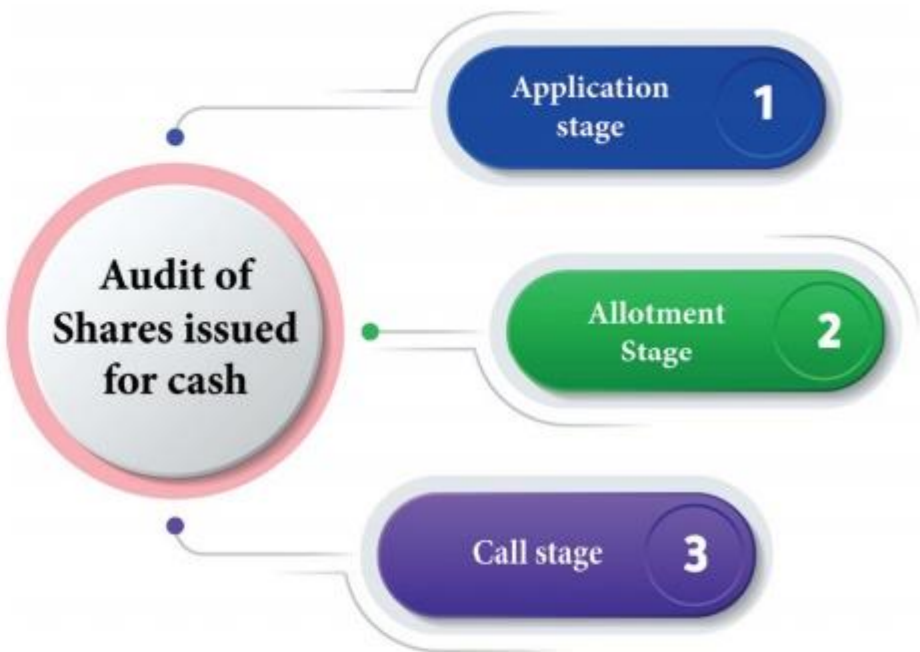
Rights issue is the pro- rata issuance of equity to existing equity shareholders in the company. This results in the advantages such as control in the hands of existing shareholders, prevention of dilution of control and less costly.

Auditors Duties

The issue of share capital should be audited by the auditor. He should study the conditions relating to the issue of share capital in the Memorandum, Articles of Association, as well as Prospectus and see that these have been duly complied with. A company cannot issue share capital exceeding the amount prescribed in its memorandum though, if its Articles permit, it may increase its authorized capital by altering its Memorandum in a general meeting. Every issue of capital should be properly authorized.

Audit of Shares issued for Cash

Shares issued for cash can be done in three stages as: (a) Application Stage, where applications were received along with application money; (b) Allotment Stage, where allotment takes place and allotment money is received subject to the receipt of minimum subscription; (c) Calls stage, where calls are made on shares and the amount due is received.



a. APPLICATION STAGE

a) The auditor should check the original share application. He should check the entries in Application and Allotment Book.

b) He should vouch the application money received with Application and Allotment Book and the corresponding entries in cash book. He should ensure that application money received was deposited in a scheduled bank until the certificate of commencement of business is obtained. He should verify whether application money received is not less than 5% of the nominal value of shares issued.

c) He should vouch the money refunded to unsuccessful applicants with Application and Allotment Book, copies of letters of regret and bank book.

d) He should check the total columns of Application and Allotment Book and see that proper journal entries have been passed in the books.

b. ALLOTMENT STAGE

a) The auditor should see that allotment begins only after the receipt of minimum subscription.

b) He should examine the Directors' Minute Book to see that all the allotments have been approved by the Board.

c) He should compare the copies of Letters of Allotment and Letters of Regret with entries made in the Application and Allotment Book.

d) He should check the amount received on allotment, by comparing Application and Allotment Book with Cash Book.

e) He should check the postings in Share Register of the amount received on application and allotment.

f) He should see that the relevant RBI and FEMA requirements, in case of allotment to non-residents.

g) He should see that appropriate journal entry debiting Share Allotment and crediting Share Capital Account has been duly made.

c. CALL STAGE

a) The auditor should examine the board of director's resolution in the Directors' Minute Book for making calls.

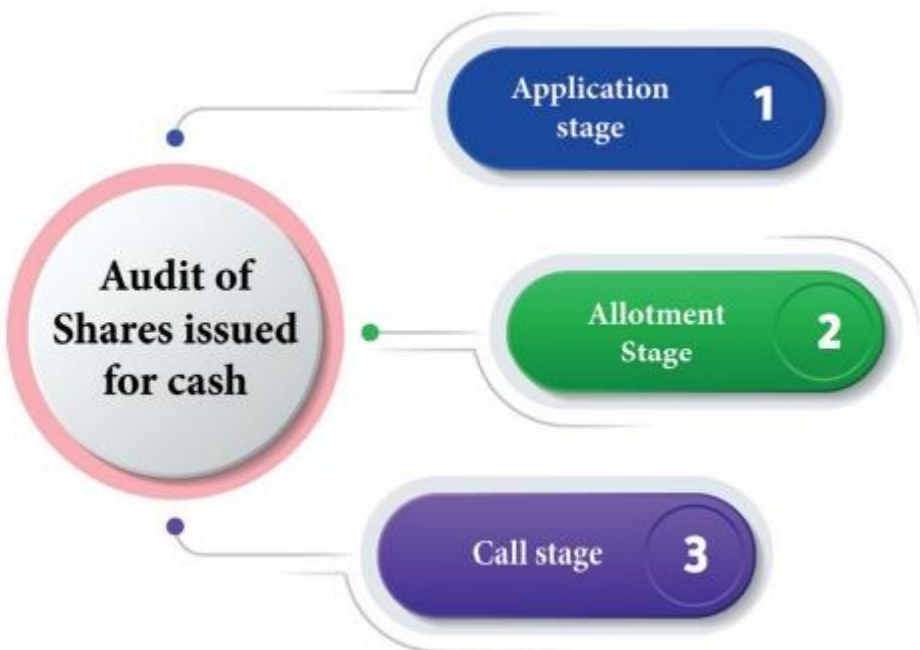
b) He should verify the amount received with the counterfoil of receipts.

c) He should compare the total amount due on calls with the amount collected and entered in the cash book. He should trace out the figures of call-in-arrears by comparing the 'Schedule of Calls in Arrears' with Application and Allotment Book, and check the accuracy of the amount.

d) He should see that appropriate journal entry debiting Calls Account and crediting Share Capital Account has been duly made.

Audit of Shares issued for Cash

Shares issued for cash can be done in three stages as: (a) Application Stage, where applications were received along with application money; (b) Allotment Stage, where allotment takes place and allotment money is received subject to the receipt of minimum subscription; (c) Calls stage, where calls are made on shares and the amount due is received.



a. APPLICATION STAGE

a) The auditor should check the original share application. He should check the entries in Application and Allotment Book.

b) He should vouch the application money received with Application and Allotment Book and the corresponding entries in cash book. He should ensure that application money received was deposited in a scheduled bank until the certificate of commencement of business is obtained. He should verify whether application money received is not less than 5% of the nominal value of shares issued.

c) He should vouch the money refunded to unsuccessful applicants with Application and Allotment Book, copies of letters of regret and bank book.

d) He should check the total columns of Application and Allotment Book and see that proper journal entries have been passed in the books.

b. ALLOTMENT STAGE

a) The auditor should see that allotment begins only after the receipt of minimum subscription.

b) He should examine the Directors' Minute Book to see that all the allotments have been approved by the Board.

c) He should compare the copies of Letters of Allotment and Letters of Regret with entries made in the Application and Allotment Book.

d) He should check the amount received on allotment, by comparing Application and Allotment Book with Cash Book.

e) He should check the postings in Share Register of the amount received on application and allotment.

f) He should see that the relevant RBI and FEMA requirements, in case of allotment to non-residents.

g) He should see that appropriate journal entry debiting Share Allotment and crediting Share Capital Account has been duly made.

c. CALL STAGE

a) The auditor should examine the board of director's resolution in the Directors' Minute Book for making calls.

b) He should verify the amount received with the counterfoil of receipts.

c) He should compare the total amount due on calls with the amount collected and entered in the cash book. He should trace out the figures of call-in-arrears by comparing the 'Schedule of Calls in Arrears' with Application and Allotment Book, and check the accuracy of the amount.

d) He should see that appropriate journal entry debiting Calls Account and crediting Share Capital Account has been duly made.

Audit of shares issued for consideration other than cash

Shares may also be issued for consideration other than cash. Vendors, promoters, underwriters, etc.may be allotted shares instead of making payments to them. The audit procedure followed in this regard involves examining the contract, board of director's resolution, checking the journal entries and examining the prospectus.

Meaning

Shares issued for consideration other than cash may arise where a company issues shares to vendors of business against purchase consideration; or to promoter's who have borne preliminary expenses, or to underwriters against settlement of under-writing commission, etc.

Auditors Duties

1. Examination of Contracts:

Copy of contracts entered into with vendors, promoters, underwriters, etc. should be examined by the auditor to ensure that the allotment is made as per the agreements. The amount of purchase consideration for the vendors, nature and amount of consideration for the promoters, remuneration to underwriters would be mentioned in their respective agreements.

2. Examination of Prospectus:

He should examine the Prospectus to ensure that conditions lay down such as details of the amount payable to the vendors, promoters, and underwriters and the mode of payment.

3. Verify Directors Minute Book:

The auditor should examine the Minutes of the Board of Directors to ensure that the allotment is authorized by the Board.

4. Verify Entries in Books:

The auditor should see that the journal entry is in order. He should verify Share capital account as shown in the ledger to ascertain that share allotments are posted in the ledger accounts.

e. Compliance with Legal Provisions

The auditor should verify the return filed with the Registrar of Companies to ensure that return is filed in accordance with the provisions of the Act.

Audit of Shares Issued at Premium

Share premium can be defined as the excess amount received by the company over and above the face value of shares. All types of companies can issue shares at premium. The auditor should examine the Prospectus, the Articles and the Minutes of the Directors to see whether the issue of shares at a premium is duly authorized or not. He should see that the sum available has been utilized in the manner as laid down by the Articles.

Meaning of Shares Issued at Premium

Share premium means the shares are issued at an amount in excess of the nominal value of the shares. Section 52, of the Companies Act, 2013 states that, if a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a Share Premium Account. The auditor should examine the Articles, Minutes of Board meetings to see whether issue of shares at a premium is duly authorized.

Auditors Duties for Issue of Shares at Premium

The auditor should see that the amount of share premium is utilized in the manner laid down in Section 52. The share premium account may be used by the company only for –

- Issuing fully paid bonus shares to the members of the company.
- Writing off preliminary expenses or commission paid or discount allowed on any issue of shares or debentures of the company.
- Providing for the premium payable on the redemption of any redeemable preference shares of the company.
- Buying back own shares, if Articles permits it and authorized by special resolution passed in general meeting.

Meaning

According to Section 53, a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54, of the Companies Act, 2013. Sweat Equity share means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. If a company contravenes the provisions of this section, it shall be punishable with a fine not less than one lakh rupees but it may extend upto five lakhs. Moreover, the official in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

Auditors Duties

The auditor should see whether the following conditions are fulfilled in case of Sweat Equity Shares:

1. The issue should be authorized by a special resolution. The number of shares, current market price, consideration to be received, if any, and the class of directors, employees to whom the shares will be issued should be specified in the special resolution.

2. Only after expiry of at least one year from the date of commencement of company's business, these shares can be issued.

3. If shares of the company are listed on the stock exchange, issue of sweat equity shares will be in accordance with regulations made by SEBI.

Meaning of Dividend:

A Dividend is payment made by a Company to its shareholders, usually as a distribution of profit.

Duties of Auditors on Distribution of Dividends

Duties of Auditor regarding the distribution of dividends

The auditor should perform the following duties regarding the distribution of dividend:

1. The auditor should examine the Memorandum of Association and Articles of Association of the company under audit to ascertain the rights of shareholders holding different classes of shares.

2. As stated already if the rate of dividend exceeds 10% of the profits of the year, the company is required to transfer not less than 2.5% of profit to the reserve account. It is the duty of the auditor to verify whether the company has appropriated the profit accordingly and whether the company has obtained any consent from the Central Government in this regard.

3. The auditor should examine the Minutes of the General Meeting and the Board of directors to confirm the amount of dividend recommended by the directors and declared in the general meeting.

4. He should verify the dividend payments with the bank pass book.

5. Register of Members and dividend list are to be compared and the dividend payable to each shareholder is to be verified. If dividend is taxable at the hands of the shareholder, the amount of tax to be deducted at source is to be checked.

6. The auditor should check the dividend warrants surrendered with the dividend paid. He should also check the outstanding dividend warrants with the balance in dividend account.

7. He should see whether company has opened a separate account in a scheduled bank as "***Unpaid Dividend Account of "X" Co., Ltd.***" and transfer the total amount of dividend remaining unpaid within 30 days from declaration of dividend. The amount is to be transferred to the account within 7 days from the date of expiry of thirty days. The auditor should ensure that the company has followed the above procedure regarding the unpaid/unclaimed dividend.

8. If such dividend remains unclaimed for a period of seven years, it is to be transferred to Investor Education and Protection Fund. The auditor should see whether the provision is duly complied with.

Audit of Debentures | Role of Auditors

Role of An auditor in verification of documents in audit of debentures

The following are some of the roles of auditors in document verification pertaining to audit of debentures.

1. First, the auditor should ensure that the company has complied with SEBI guidelines.

2. Debenture Trust Deed should be examined by the auditor to make sure that the company adheres to the conditions prescribed by the Trust Deed.

3. The auditor should also verify whether the prospectus was filed before the due date.

4. He should verify the names, and addresses of the allottees and whether the allotment is authorized by the directors.

5. He should compare the Debenture Register with the ledger and ensure that the amount collected is duly accounted for.

6. It is known that debentures can be issued for cash, for consideration other than cash or as collateral security. In case debentures are issued as collateral security, the auditor has to examine the mortgage deed and ensure that the charge is recorded and also that it is registered with the Registrar of Companies. He should also verify whether the charge is clearly disclosed in the balance sheet.

7. If debentures are issued at a premium, the auditor should ensure that the premium account is treated as capital profit and accounted separately.

8. In the same way, if the debentures are issued at a discount, the auditor should ensure that the discount account is written off over the life time of the debenture or within a reasonable time.

9. If the debentures are to be redeemed at a premium, the balance sheet may show premium on redemption of debenture at the liability side of the balance sheet until the debentures are redeemed or the company may disclose the fact that the debentures are to be redeemed at premium by way of a note in the balance sheet.

Role of an Auditor in verifying the payment of interest on debentures

1. On verifying the payment of interest, the auditor should vouch the payment with the acknowledgement received from the debenture holders or with the coupon surrendered for the bearer Debentures.

2. The auditor should ascertain the total amount payable as debenture interest, the amount paid and the balance interest payable.

3. He should also ensure that the amount payable as debenture interest for the period is debited to the Profit 4 Loss Account.

4. **Re-issue of Redeemed Debentures**: Unless the Articles of Association or an agreement or a resolution prohibits, redeemed debentures can be reissued.

5. **Debentures issued as Collateral Security**: It is known that debentures can be issued as collateral security against loan. The total face value of such debentures will be exceeding the loan amount by 10% to 20%. Such collateral debentures are disclosed in the balance sheet, only by way of a note. Such debentures will become effective only when the company makes a default in repayment of loan. The auditor should verify whether the issue of debentures as collateral security is approved by the board and the charge is registered with the Registrar of Companies.

PART –A

1. What is financial statement audit?
2. How long the company Preservation of Financial Statements?
3. What is meant by Audit of share capital?
4. What is meant by Audit of dividends?
5. What is meant by Audit of Debentures?

PART-B

1. Explain the presentation of Financial statements?
2. Discuss Special requirements of a company audit
3. Discuss audit of Share Capital
4. Explain Duties of Auditor regarding the distribution of dividends
5. Explain Auditors Duties for Issue of Shares at Premium

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