# Auditing

## Principles and Practices


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Mc Graw Hill Education

# AUDITING

## Principles and Practices

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# PREFACE

Globally, the concept of Auditing has undergone a radical change in its approaches, principles and procedures. At the same time auditors of the $21^{st}$ century must be prepared to "audit" virtually anything—operations (including control systems), performance, information and information systems, legal compliance, financial statements, fraud, environmental reporting and performance, and quality. All these elements have made the subject quite dynamic and at the same time complicated too. The constant changes in the regulatory framework relevant to its conduct further add to the complexity of the subject.

In India, the regulatory changes during the past few years have brought a paradigm shift in the approach of Accounting and accordingly Auditing. The introduction of The Companies Act, 2013 along with all the associated rules (including Company Auditor's Report Order, 2015), promulgations from the Institute of Chartered Accountants of India and more recently the introduction of new set of converged Indian Accounting Standards (Ind AS) have made the concept of Auditing more rule-based than being principle-based.

Keeping this in mind, this book has been written with the objective to describe the modern tools and techniques of auditing in a student-friendly approach. The contents of the book have been lucidly explained point-wise with appropriate examples wherever necessary. The key points are summarised at the end of each chapter. Model questions along with the answers have also been included at the end of the book to provide ample scope for practice and at the same time making students well-versed with the exam pattern.

This book is intended primarily for the commerce students pursuing undergraduate courses from University of Calcutta and other Universities of Eastern India.

We believe that our present endeavor will be beneficial for our readers.

**Authors**

# ACKNOWLEDGEMENTS

This book would not have been possible without the unstinting support of many people. We take this opportunity to offer our sincere thanks to all of them. It is a great pleasure to express our deep sense of gratitude to all our respected teachers associated with the Department of Commerce, University of Calcutta, who have enriched our academic knowledge and outlook and have also given us valuable suggestions in drafting this book.

We also express our deep gratitude and indebtedness to all the renowned authors on this subject from whom references have been taken.

We are immensely benefited from the interactions we had with our friends, teachers of different colleges and universities at different points of times.

We are grateful to the editorial and production teams at McGraw Hill Education (India) Private Limited for their constant support and encouragement in publishing this book. Specially, we would like to offer our sincere thanks to Mr. Suman Sen, Mr. Amit Chatterjee and Mr. Atul Gupta for sparing their valuable time in going through our drafts and providing invaluable suggestions.

Last but not the least, we also acknowledge the endless support of our family members who had to sacrifice quality time spent due to our continuous engagement in this venture.

Any suggestions for the improvement of the book from professionals, teachers, students and other readers will be very much appreciated.

**Authors**

# SYLLABUS

## UNIVERSITY OF CALCUTTA

### B.Com. Part – II (Hons.)

### Paper 2.3 Ch: AUDITING

**Module I – 50 marks**

**Unit 1: Introduction** **(10 Marks)**

- *Definition* – Nature, Scope and Objectives of Independent Financial Audit, Limitation.
- *Basic Principles Governing an Audit* – Relation between Accounting and Auditing.
- *Errors and Fraud* – Concepts, Means of doing Fraud, Purpose, Conditions which increase the Risk of Fraud and Error, Auditor's Responsibility towards Detection and Reporting.
- *Classification* – Objective-wise (Internal and Independent Financial Audit), Periodicity-wise (Periodical, Continuous, Interim, Final, Limited Review), Technique-wise (Balance sheet, Standard, Systems, EDP), Coverage-wise (Complete, Partial), Organisation structure-wise (Statutory, Non-statutory), [Specific matter-wise (Cost, Management, Secretarial, Tax, Environment, Human Resource, Social, Operational, Propriety, Stock, Public Deposit, Corporate Governance, Cash Flow, Compliance, Performance etc.).]*

**Unit 2: Auditing Procedures and Techniques** **(10 Marks)**

- *Auditing Engagement* – Audit Planning, Audit Programme.
- *Documentation* – Audit Working Papers, Ownership and Custody of Working Papers.
- *Audit File (Permanent, Current)* – Audit Note Book, Audit Memorandum.
- *Audit Evidence* – Concept, Need, Procedure to Obtain Audit Evidence, Sources and Reliability, Methods.
- Preparation Before Commencement of a New Audit.

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* The topics mentioned in parentheses [ ] have been although excluded from the prescribed syllabus; however have been covered in the book for the basic understanding of the subject.

**Unit 3: Internal Control and Internal Audit** **(10 Marks)**

- *Internal Check* – Definition, Objective, Preparation of Checklists.
- *Internal Control* – Definition, Objectives, Evaluation, Internal Control in Computerised Environment, ICQ and its Preparation, Comparison with Internal Check.
- *Internal Audit* – Definition, Objectives, Regulatory Requirements (Companies Act), Reliance by Statutory Auditor on Internal Auditor's Work.

**Unit 4: Audit Sampling and Analytical Procedure** **(10 Marks)**

- *Concept, Need, and Types of Sampling* – Sampling Risk, Stages in Audit Sampling.
- *Test Checking* – Auditing in Depth and Cut-off Checking.
- *Analytical Procedure* – Nature and Application of Analytical Procedure, Tools and Techniques of Analytical Procedure, Extent of Reliance on Analytical Procedure, Use of Analytical Procedure for Substantive Testing.

**Unit 5: Audit (Vouching and Verification) of Different Items** **(10 Marks)**

- *Vouching* – Meaning, Objectives, Vouching of Different Items (Receipts and Payments Related).
- *Verification* – Concept, Objectives, Audit of Share Capital, Loans (Secured and Unsecured), Fixed Assets (Building, Plant and Machinery, Loans and Advances, Investment, Goodwill, Copy Right, Patent Right Inventories, Debtors), Creditors, Subsequent Events, Preliminary Expenditures, Directors' Remuneration etc.

***Note:*** *Topics to be studied with reference to relevant Standards on Auditing and Accounting including applicable Indian Financial Reporting Standards.*

## Module II – 50 marks

**Unit 1: Company Audit** **(14 Marks)**

- Qualification, Disqualification, Appointment, Removal, Remuneration of Auditors.
- Audit Ceiling, Status, Power, Duties and Liabilities of Auditors.
- Branch Audit, Joint Audit, Special Audit.
- Maintenance of Books of Account, Segment Reporting.
- Divisible Profit, Dividend and Depreciation (Companies Act, Standards on Accounting, Legal Decisions and Auditor's Responsibility).
- Contents of Annual Report (A Brief Idea).

**Unit 2: Audit Report and Certificate** **(10 Marks)**

- Definition, Distinction between Report and Certificate, Types of Reports/Opinion (Clean, Qualified, Disclaimer, Negative and Piecemeal).
- Contents of Audit Report (As per Companies Act and Standards on Auditing).
- True and Fair View (Concept and Guiding Factors), Materiality(Concepts and Relevance).

**Unit 3: Audit of Different Institutions** **(10 Marks)**

- *Banks* – Legislation Relevant to Audit of Banks, Approach to Bank Audit, Internal Control Evaluation, Non-Performance Assets (Concept, Provisions), Long Form Audit Report.
- *Insurance Companies* – Legislation Relevant to Audit of Insurance Companies (Life and General Insurance), Review of Internal Control, Audit Report (Matters as per IRDA).
- Educational Institutions and Hospital.
- *Features and Basic Principles of Government Audit* – Local Bodies and Non-Profit Seeking Organisations (including NGOs).
- Comptroller and Auditor General and its Constitutional Role.

**Unit 4: Investigation** **(6 Marks)**

- Meaning, Purpose, Distinction between Investigation and Auditing Approach to Investigation, Types of Investigations.
- Investigations to Detect Fraud, Misappropriations and Defalcations, Investigations with respect to Business Combinations.

**Unit 5: Other Thrust Areas** **(10 Marks)**

- *Cost Audit* – Concepts, Objectives, Advantages, Relevant Provisions of Companies Act.
- Management Audit, Tax Audit, Systems Audit, Social Audit, Environment Audit, Propriety and Performance Audit (Concepts, Objectives and Regulatory Requirements).
- *Ethics in Auditing* – Auditor's Independence.
- Auditing in CIS Environment.
- *Standards in Auditing* – Concepts, Purpose and Present Position as to Number and Title as issued by ICAI.

***Note:*** *Topics to be studied with reference to Standards on Auditing and Accounting including applicable Indian Financial Reporting Standards.*

# Contents

*Preface* *vii*
*Acknowledgements* *ix*
*Syllabus* *xi*

**1. Introduction** **1.1–1.44**

1.1 Introduction *1.1*
1.2 Auditing *1.2*
1.3 Principles Governing an Audit *1.11*
1.4 Auditing and Other Fields of Knowledge *1.12*
1.5 Auditing as a Social Science *1.14*
1.6 Errors and Frauds *1.14*
1.7 Classification of Auditing *1.20*
*Summary* *1.40*
*Exercise* *1.42*

**2. Audit Procedures and Techniques** **2.1–2.25**

2.1 Auditing Engagement *2.1*
2.2 Audit Planning *2.3*
2.3 Audit Programme *2.5*
2.4 Audit Note Book *2.10*
2.5 Audit Memorandum *2.12*
2.6 Audit File *2.13*
2.7 Audit Working Paper *2.14*
2.8 Audit Evidence *2.17*
2.9 Preparation before Commencement of a New Audit *2.21*
*Summary* *2.23*
*Exercise* *2.24*

**3. Internal Control and Internal Audit** **3.1–3.33**

3.1 Introduction *3.1*
3.2 Internal Check *3.2*
3.3 Internal Check—Preparation of Check-lists *3.6*
3.4 Liability of the Statutory Auditor for Relying on Internal Check System *3.6*
3.5 Internal Check System for Some Transactions *3.7*
3.6 Internal Control *3.12*
3.7 Comparison between Internal Control and Internal Check *3.18*
3.8 Internal Control in a Computerised Environment *3.19*
3.9 Meaning of Internal Control Questionnaire (ICQ) and Preparation of ICQ *3.20*
3.10 Internal Audit *3.24*
3.11 Differences between Internal Check and Internal Audit *3.27*
3.12 Differences between Internal Control and Internal Audit *3.28*
3.13 Comparison between Internal Control, Internal Audit and Internal Check *3.28*
3.14 Legal Requirement of Internal Audit *3.29*
3.15 Relying upon the Work of Internal Auditor *3.30*
*Summary 3.30*
*Exercise 3.31*

**4. Audit Sampling and Analytical Procedure** **4.1–4.26**

4.1 Audit Sampling *4.1*
4.2 Audit Procedures *4.8*
4.3 Analytical Procedure *4.20*
*Summary 4.24*
*Exercise 4.25*

**5. Vouching** **5.1–5.31**

5.1 Meaning of Vouching *5.1*
5.2 Definition of Vouching *5.2*
5.3 Features of Vouching *5.2*
5.4 Objectives of Vouching *5.3*
5.5 Importance of Vouching *5.3*
5.6 Principles or Techniques of Vouching *5.5*
5.7 Vouching and Routine Checking *5.6*
5.8 Concept of Voucher *5.7*
5.9 Features of Valid Vouchers *5.7*
5.10 Types of Voucher *5.8*
5.11 Duties of an Auditor for Missing Vouchers *5.8*

5.12 Vouching of Different Items (Receipts and Payments Related) *5.9*
*Summary 5.28*
*Exercise 5.30*

**6. Verification and Valuation** **6.1–6.40**
6.1 Verification *6.1*
6.2 Window Dressing and Verification *6.5*
6.3 Difference between Vouching and Verification *6.5*
6.4 Valuation of Assets and Liabilities *6.6*
6.5 Difference between Verification and Valuation *6.10*
6.6 Verification and Valuation of Assets *6.11*
6.7 Verification and Valuation of Liabilities *6.30*
*Summary 6.36*
*Exercise 6.37*

**7. Company Audit** **7.1–7.81**
7.1 Introduction *7.1*
7.2 Company Auditor *7.2*
7.3 Branch Audit *7.26*
7.4 Joint Audit *7.27*
7.5 Maintenance of Books of Accounts *7.30*
7.6 Related Party Disclosures *7.33*
7.7 Segment Reporting *7.40*
7.8 Divisible Profits and Dividends *7.45*
7.9 Depreciation *7.61*
7.10 Written Representation by Management *7.69*
7.11 Annual Report *7.72*
7.12 New Areas under Companies Act, 2013 *7.75*
*Summary 7.79*
*Exercise 7.80*

**8. Audit Report and Certificate** **8.1–8.22**
8.1 Introduction *8.1*
8.2 Auditor's Report *8.1*
8.3 Contents of Audit Report (as per Companies Act and Standards on Auditing) *8.8*
8.4 Auditor's Certificate *8.13*
8.5 Companies (Auditor's Report) Order 2015 (CARO, 2015) *8.14*
8.6 True and Fair View *8.17*

8.7 Materiality *8.18*
*Summary 8.20*
*Exercise 8.20*

**9. Audit of Different Institutions** **9.1–9.40**
9.1 Introduction *9.1*
9.2 Bank Audit *9.2*
9.3 Legislations Relevant to Audit of Banks *9.3*
9.4 Approach to Bank Audit *9.5*
9.5 Audit of Banks—Provisions, Procedure, Internal Control *9.6*
9.6 Non-Performing Assets *9.10*
9.7 Long Form Audit Report of Banks *9.12*
9.8 Audit of Insurance Companies *9.14*
9.9 Audit of Educational Institutions *9.19*
9.10 Audit of Cooperative Societies *9.21*
9.11 Audit of Hospital and Nursing Home *9.22*
9.12 Audit of a Club *9.23*
9.13 Audit of Hotel and Restaurant *9.24*
9.14 Audit of Cinema Hall *9.26*
9.15 Audit of Public Library *9.27*
9.16 Government Audit *9.28*
9.17 Audit of Local Body or Local Self Government *9.30*
9.18 Audit of Non-Profit Seeking Organisations (NGOs) *9.32*
9.19 Comptroller and Auditor General of India *9.34*
*Summary 9.37*
*Exercise 9.39*

**10. Audit Investigation** **10.1–10.16**
10.1 Introduction *10.1*
10.2 Characteristics/Features of Investigation *10.1*
10.3 Purpose of Investigation *10.2*
10.4 Distinction between Auditing and Investigation *10.3*
10.5 Types of Investigations *10.4*
10.6 Investigations in Certain Situations *10.6*
*Summary 10.15*
*Exercise 10.15*

**11. Other Thrust Areas** **11.1–11.65**
11.1 Introduction *11.1*
11.2 Cost Audit *11.2*

11.3 Management Audit *11.12*
11.4 Tax Audit *11.19*
11.5 System Audit *11.22*
11.6 Social Audit *11.25*
11.7 Environmental Audit *11.28*
11.8 Propriety Audit *11.31*
11.9 Performance Audit *11.34*
11.10 Professional Ethics *11.37*
11.11 Auditor's Independence *11.42*
11.12 Audit under Computerised Information System (CIS) Environment *11.47*
11.13 Standards on Auditing *11.55*
*Summary 11.61*
*Exercise 11.63*

**Model Questions and Answers** **MQA.1–MQA.78**

**Appendix-I** List of Companies Rules Issued in Pursuant with the Companies Act, 2013 **A.1–A.2**

**Appendix-II** List of Indian Accounting Standards (Ind AS) **A.3–A.4**

**Calcutta University Question Paper 2017 with Solutions** **QP.1–QP.25**

# 1 CHAPTER

# INTRODUCTION

**CHAPTER OUTLINE**


**1.1** Introduction
**1.2** Auditing
**1.3** Principles Governing an Audit
**1.4** Auditing and Other Fields of Knowledge
**1.5** Auditing as a Social Science
**1.6** Errors and Frauds
**1.7** Classification of Auditing


## 1.1 INTRODUCTION

Financial statements i.e. income statement and the statement of affairs are the end products of any formal accounting system. They are often used by various interested parties in making useful decisions. Accordingly, authenticity, truthfulness and fairness are considered to be the essential characteristics of these statements so as to make them really worthy to support a decision making process. However, mere recording of transactions in the books of accounts may not be sufficient enough to ensure the above qualities. Considering the possibility of unintentional mistakes or errors and well organised frauds, an independent appraisal of the recorded facts is imperative. Auditing, in its fundamental form, ensures the above appraisal of financial accounting data and management assertions and thereby supports the decision making process of the stakeholders.

Moreover, the newer dimensions of audit extend the above appraisal practice beyond the traditional financial accounting data and thereby address issues more specific and more focused. Today auditing plays a multifaceted dynamic role in almost all the important functional areas of an organisation.

## 1.2 AUDITING

### 1.2.1 Meaning and Definition of Audit

The concept of audit has undergone constant change over the years. Hence it is required that the meaning of the term 'audit' is analysed both in the (traditional) narrow and (modern) broad sense of the term.

#### A. Narrow Perspective

The word 'Audit' is derived from the Latin word 'audire' which means 'to hear'. In early days, an auditor usually listened to the accounts read out by the accountant in order to check its authenticity. In those days, in the case of suspected fraud in an organisation, the owner of the business used to appoint a person to verify the accounts and listen to the explanations given by the person responsible for keeping the accounts and funds.

Some of the definitions given by a few well-known experts in the field indeed highlight the above narrow perspective.

According to Montgomery, auditing is a systematic examination of the books and records of a business or other organisation in order to ascertain or verify and to report upon the facts regarding the financial operations and the results thereof.

In the words of Spicer and Peglar, an audit is such an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up so as to give a true and fair view of the state of affairs of the business and whether Profit and Loss account gives a true and fair view of the profit and loss for the financial period, according to the best of the information and explanation given to him and if not, to report in what respect he is not satisfied.

Thus, in its narrow sense, the scope of an audit is limited to only authenticating the accounting records and thereby to assure the accuracy and reliability of the financial statements and reports.

#### B. Broad Perspective

With the changes in socio-economic environment, the concept of audit has been reshaped. Today auditing is not confined to mere authentication of financial accounting records. It is now considered to be an independent appraisal activity that extends itself towards evaluation of non-financial aspects as well.

As per the General Guidelines on Internal Auditing issued by the Institute of Chartered Accountants of India (ICAI), "auditing is a **systematic** and **independent** examination of **data**, **statements, records, operations** and **performance** (financial and otherwise) of an enterprise for a **stated purpose**."

Thus, in order to address the specific objectives auditing must go beyond the numbers and reports and should also evaluate all the relevant aspects of operations and performance of the organisation in a systematic and unbiased approach. Even an auditor may have to evaluate

the propriety of the decision taken by the management and compliance of the records with the available regulatory framework.

Thus, in the broader perspective auditing is a holistic appraisal of all the relevant aspects (be it financial or otherwise) of an enquiry sought after a stated purpose.

### 1.2.2 Evolution of Audit

The evolution of audit as a separate discipline as well as a profession can be discussed in four phases as follows –

#### A. First Phase

Auditing, being an examination of accounts (in its primitive form at least) evolved with the development of accounting. However, even in ancient times, auditing did exist. Historical evidences suggest that audit of state accounts was an established practice in Greece, Egypt and Rome. As soon as new states were acquired, public accounts were checked coherently to know the position of the treasury. Similar practices were prevalent in India and other parts of the world also. The legendary 'Arthashastra' written by Kautilya, a minister of Mouryan emperor Chandragupta, contains evidence of a well organised accounting and auditing system of state treasury. However, auditing during these years were limited to only public accounts. This is because, privately owned business organisations were small in size and a result owner himself could examine the business accounts.

#### B. Second Phase

The last decade of the fifteenth century witnessed significant development in trade and commerce due to the Renaissance in Italy. This necessitated the introduction of a formal system of accounting applicable for all types of transactions. Coincidentally, during this period (in 1494), Luca Pacioli, a mathematician from Italy, published a book titled '*Summa de Arithmetica, Geometria, Proportioni et Proportionalita*', which had a dedicated chapter on double entry book keeping system. Pacioli's book paved the way for a whole host of literature in the similar lines which significantly helped in improving the existing accounting system into a formal one. With the development in accounting, auditing as a process of examination of the reliability of recorded facts also became important.

#### C. Third Phase

Industrial revolution in England in eighteenth century and subsequent developments led by it was another landmark in the history of trade and commerce. Keeping pace with the expansion of organisations, introduction of mechanised production system, large scale production etc. railroads were established in Nineteenth century. All these significantly affect the nature, organisation structure, ownership and control of business. Apart from proprietorship and partnership form of business came the Joint Stock Company form of organisations. Since in a company form of business ownership is explicitly separated from the management, concept

of stewardship became relevant. Moreover, the perpetual legal existence of Joint Stock Companies significantly changed the system of accounting. Reporting of the final outcome of business transactions assumed greater importance to ensure the appropriate use of funds by the management. All these increased the need for an independent appraisal of accounting records and reports by a qualified third party. Auditing, in its formal shape started being used extensively in almost all the countries.

#### D. Fourth Phase

Introduction of Cost Accounting during the end part of the Nineteenth Century and Management Accounting during the middle of Twentieth Century further extended the scope of auditing. As a result, auditing ceased to remain confined within authentication of recoded numbers and reports. Evaluating the performance, determining propriety and recommending the future course of action also got included in the broader scope of auditing. Today, auditing has assumed a multi-dimensional approach to achieve business solutions.

### 1.2.3 Development of Audit Profession in India

Though auditing in its formal structure was introduced in India during the British rule, the history of accounting and auditing can be traced back to the ancient times.

#### A. Auditing in Ancient India

In India, accounting and auditing existed even before the vedic period. A number of pre-vedic and vedic literature has clear mention about the existence of a system of accounting and examination of accounts. In Mahabharata, we find a reference where Nakula, the fourth Pandava, was appointed by King Yudhistira to oversee the accounts of the army. During the Mauryan era also there existed a well organised accounting and auditing system of state accounts as evident from 'Arthashastra', written by Kautilya, the legendary minister of King Chandragupta. Not only that, in 'Arthashastra', Kautilya narrated forty different kinds of frauds and embezzlements that were likely to be committed while processing the state accounts. Mention of accounting and auditing is also found in literatures during the Gupta rule. Guptas had levied tax on profits and also had a well organised system of collection and accounting of taxes.

#### B. Auditing in Medieval India

During the ancient and medieval period also there was well established system of accounting and auditing. Sultans appointed Mushrifs and Mustafis to maintain accounts and to audit the same. During the Mughal period, Badshah Akbar reformed the tax structure of the state and also implemented measures for collection, accounting and auditing of taxes. He appointed Mansabdars for different parts of the state and mandated proper record keeping of all taxes collected. These records were subjected to verification by the officials sent by the emperor.

### C. Auditing during British Rule

The Joint Stock Companies Act, 1857 first introduced the requirement of audit of company accounts. Since India was under British Rule the provisions were equally applicable in India also. However, only the members of professional chartered accountants of England and Wales were allowed to audit the accounts of companies. Later Companies Act, 1913 mandated audit of company accounts. Moreover, the Act also specified the qualifications of a company auditor and empowered the Provincial Govt. to conduct examination and to issue certificates to successful candidates to act as auditors. In 1918, Bombay Govt. first conducted a written examination and awarded the successful candidates 'Government Diploma in Accountancy (GDA)' who could act as the company auditors. This system was in existence till the introduction of Auditor's Certificate Rules in 1932. After the introduction of this Rule, the Central Govt. took over the power to issue certificates to act as auditors and established Indian Accountancy Board to bring uniformity in audit of company accounts all over India. Subsequently, the Central Govt. started maintaining a Register of licensed accountants. These professional were known as Registered Accountants (RA). Before the introduction of Chartered Accountants Act, 1949, only these Registered Accountants were allowed to act as the company auditors in India.

### D. Post Chartered Accountants Act, 1949

In 1949, Central Govt. introduced the Chartered Accountants Act, 1949 with the objective to regulate the auditing profession in India. Accordingly, the Institute of Chartered Accountants of India (ICAI) was established. The Council of the Institute was empowered to impart education and training to the members (i.e. qualified chartered accountants) and to ensure the professional ethics and discipline on the part of the practitioners. In 1950, the Constitution of India introduced a post of Comptroller and Auditor General of India (CAG) as the Supreme Audit Institution (SAI) for government accounts. In 1971, Indian Parliament passed the Comptroller and Auditor General (Duties, Powers, Conditions of Service) Act to specify and thereby regulate the duties and power of CAG. In 1956, the new Companies Act replaced the previous 1913 Act. The new Act significantly widened the scope of company audit in India. Considering the need to have a separate section of specialised audit professional for auditing accounts of manufacturing companies, the Parliament passed the Cost Accountants Act in 1959. Accordingly, the Companies Act, 1956 mandated u/s 233B the audit of cost accounts by qualified cost accountants for a certain class of companies. In 1988, Central Govt. introduced Manufacturing and Other Companies (Auditor's Report) Order which was subsequently replaced by Companies (Auditor's Report) Order 2003. These rules mandated reporting on various issues other than the truthfulness and fairness of financial statements. In 1984, Central Govt. introduced compulsory Tax Audit through an amendment to the Income Tax Act, 1961. In 1985, RBI instructed banks to ask for audited accounts from the applicants of loans of a sizeable amount. All these led to a tremendous growth of audit profession in India.

### E. Post Companies Act, 2013

Very recently, the Companies Act, 2013 replaced the age old Companies Act, 1956 to incorporate a number of timely changes in the way the company accounts are maintained and

audited. Accordingly, internal auditing has been made mandatory for all listed and a few other classes of companies, compulsory rotation of auditors has been introduced, audit committees have been made more relevant and secretarial audit is also introduced along with many other changes. All these are expected to make the audit profession more reliable and dynamic.

### 1.2.4 Nature of Audit

The nature or characteristics of an audit are summed up below:

(i) Audit is a **systematic and scientific examination** of the books of accounts of a business.

(ii) Audit is undertaken by an **independent** person or body of persons who are duly qualified for the job.

(iii) Audit is a **verification** of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.

(iv) Audit is a **critical review** of the system of accounting and internal control.

(v) Audit is done with the help of vouchers, documents, information and explanations received from the authorities.

(vi) The auditor has to satisfy himself with the **authenticity** of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.

(vii) The auditor has to inspect, compare, check, review, scrutinise the vouchers supporting the transactions and examine correspondence, minute books of shareholders, directors, Memorandum of Association and Articles of Association, etc. in order to establish the correctness of the books of accounts.

### 1.2.5 Scope of Audit

In ancient period, the scope of audit was really limited. But over the time the scope of audit has extended considerably.

The scope of an audit of financial statements is determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute of Chartered Accountants of India (ICAI). Moreover the auditor must also ensure that no relevant aspect of the organisation is left unchecked even if it is not specifically mentioned in the terms, regulations or pronouncements. Again, the terms of engagement cannot, limit the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the ICAI.

According to SA-200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, the scope of audit should cover the following aspects:

(a) The auditor shall assess the reliability and sufficiency of the information contained in the underlying accounting records and shall undertake appropriate audit procedures for this purpose. Appropriate audit procedure may include either Compliance Procedures (i.e.

study of accounting system and internal control) or Substantive Procedures (i.e. testing the authenticity, accuracy and completeness of information in accounting records).

(b) The auditor has to determine whether the relevant information is properly disclosed in the financial statements in conformity with the applicable generally accepted accounting principles and statutory requirements (i.e. requirements as per Accounting Standards and Companies Act).

(c) The auditor's work shall involve an exercise of judgement. He shall be principally concerned with items that either individually or as a group are material in relation to the affairs of an organisation.

Thus the duty of the auditor shall not be limited to mere verification of accounting entries based on the available vouchers and other documents, but he shall evaluate the authenticity of the transaction, appropriate recoding of the same in the books of accounts as well as compliance of the accounting and reporting process with prevalent statutes in this respect.

The scope of an audit, thus, depends on the following factors:

(a) The size of the organisation,
(b) Legal status of the organisation (statutory or otherwise),
(c) Purpose of audit,
(d) Agreement between the auditor and owners (in case of non-statutory audit),
(e) Adequacy and effectiveness of the internal control system of the organisation,
(f) Accounting system of the organisation,
(g) Published guidelines and standards on auditing,
(h) Relevant statutes prevalent in the country,
(i) Legal decisions on different cases.

### 1.2.6 Objectives of Audit

The objectives of an audit can be grouped into three categories: (A) Primary Objectives and (B) Secondary Objectives and (C) Social objectives; these are discussed below:

#### A. Primary Objectives

The primary objective of an audit is to substantiate the accuracy and judge the reliability of the financial statements of a particular accounting period of the organisation and to express an opinion about the truthfulness and fairness of the financial statements. Rendering opinion on financial statements by the auditor is specifically included in Standard on Auditing SA-200. This standard sets out the overall objectives of the independent auditor expelling the nature and scope of an audit designed to enable the independent auditor to meet those objectives.

#### B. Secondary Objectives

The following are the secondary objectives of audit:

(i) **Detection of Errors** Detecting errors may or may not be easy. It depends on the type of error. It is easy to locate those errors whose occurrences result in a mismatch in the total of the trial balance.

(ii) **Detection of Fraud** Fraud is difficult to detect because in most cases frauds are committed intelligently and with direct involvement of top management. However, an auditor can detect frauds if he applies reasonable skill and care in the discharge of his duties.

(iii) **Prevention of Errors** Appropriate measures can be suggested by the auditor to prevent the recurrence of errors committed earlier.

(iv) **Prevention of Fraud** An auditor can suggest ways for preventing the occurrence and recurrence of frauds.

### C. Social Objectives of Audit

In addition to the above primary and secondary objectives, audit has certain social objectives too. These are enumerated below.

**(a) To Protect Shareholders' Interest** Since the auditor is a representative of the shareholders it is his duty to ensure that the interest of the shareholders is protected. In a corporate organisation shareholders are large in number but they are scattered and not united. Most of them have no idea about their rights and duties and as such are vulnerable in the hands of the unscrupulous management. Hence protecting the interest of the shareholders is an important social objective of audit. This can be done by the auditor by bringing any irregularity to the notice of the shareholders through his audit report and thereby making them aware about the ill intentions of the management, if any.

**(b) To Stop Tax Evasion** In order to protect the national interest, it is absolutely essential that tax evasion should be stopped. Evasion of tax is a moral, social, and legal crime which adversely affects the developmental agenda of a nation by reducing the revenue of the government. Thus the objective of an audit should be to stop tax evasion. Propriety audit is extremely helpful in context.

**(c) To Safeguard against Capital Erosion** Capital erosion results from payment of dividend out of inflated profit or payment of dividend out of unrealised profit. This is very serious in the sense that it may lead to winding up of the business. Therefore one of the important social objectives of audit is to stop capital erosion by introducing innovative audit approaches like management audit, propriety audit, cost audit, operation audit etc.

**(d) To Ensure Fair Return to Investors** An important social objective of an audit is to ensure a fair return to the investors. The auditor may suggest appropriate corrective actions in policies and operations that have been found to misuse resources and thereby can contribute to enhance the profitability of the organisation.

**(e) Reasonable Price for Consumers** It is an important social objective of an audit to make sure that the consumers get the commodities at a fair and reasonable price. Therefore

the auditor must report to the shareholders all such instances where the management has unnecessarily shifted any burden of loss or cost on the consumers and thereby has increased the price illegitimately.

(f) **Fair Wages for Labourers** Another important social objective of audit is to ensure fair wages for labourers. It is essential to verify whether wages for labourers have been cut or reduced in the plea of labour cost control. Moreover the auditor must also bring to the notice of the shareholders and public any instances of violation of fair wages policy accepted in an industry.

(g) **Complying with Policies Regarding Corporate Social Responsibility** The Companies Act, 2013 has put emphasis on matters relating to 'Corporate Social Responsibility'. As per Section 135 of the Companies Act, 2013, companies belonging to the specified class must constitute a Corporate Social Responsibility Committee of the Board shall spend, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy. Thus it shall be the objective of the auditor to verify whether the company has followed the said provisions. Any violation of the said rule shall be immediately brought to the notice of the shareholders through appropriate qualifications in this final report.

### 1.2.7 Advantages of Audit

Some of the advantages of audit are listed below:

(i) **Acceptable Document to the Government** Audited accounts are acceptable by government authorities like Income Tax Department, Land Revenue Department, etc.

(ii) **Detection of Error and Fraud** Auditing helps in timely detection and prevention of errors and frauds.

(iii) **Borrowing** For obtaining loan from banks and financial institutions, previous years' audited accounts are of great help as the lenders can determine the solvency of the borrowers based on audited accounts.

(iv) **Moral Check** Audit acts as a moral check on the employees of the client. This restricts them from committing defalcations.

(v) **Settlement of Claims in Partnership Firms** In case of a partnership business, audited accounts facilitate settlement of claims on the retirement or death of a partner.

(vi) **Settlement of Insurance Claim** In event of loss of property by fire or other incidents, audited accounts help in expediting the process of settlement of claims from the insurance company.

(vii) **Vouching the Stewardship** In case of a company, audit of accounts ensure the shareholders that accounts have been duly maintained, funds are properly utilised and the management has been doing their duties seriously.

(viii) **Determining the Value of the Business** In the case of acquisition of a business, audited accounts will form the basis for determining the value of the business.

(ix) **Settlement of Disputes** Audit often aids in amicable settlement of disputes between the management and labour unions on issues like payment of bonus and higher wages.

(x) **Detection and Prevention of Wastage** Audit helps in detection of wastage which aids management to prevent the recurrence of the same in future.

(xi) **Review of Control Systems** Audit appraises and reviews the existence and operations of different controls in the organisation and reveals weakness and inadequacy in them.

(xii) **Insolvency and Bankruptcy** Audited accounts form a basis for determining action in cases relating to insolvency and bankruptcy.

(xiii) **Check Capital Erosion** By identifying areas of capital erosion, an audit can help in checking the erosion of capital.

### 1.2.8 Limitations of Audit

The limitations of audit are as follows:

(i) **All Errors and Frauds may not be Detected** It may not be possible for the auditor to detect certain errors and frauds which are committed very cleverly.

(ii) **Problem of Dependence** In verifying or valuing certain items, an auditor has to depend on the explanation, clarification and information provided by the responsible officers of the organisation. He may not get correct or complete information. As a result, if such explanation and information prove to be untrue, then the audit report is affected adversely as well.

(iii) **Dependence on Opinions of Others** In dealing with certain items, an auditor has to rely on the opinions of experts like solicitors, engineers, architects, etc. since an auditor can not be an expert in all the fields. As a result an auditor may be held responsible for any negligence on the part of the experts.

(iv) **Inherent Limitations of the Financial Statements** Limitations of audit mainly stem from limitations of financial statements. It is true that financial statements may not disclose the true picture even after audit due to inflationary trends. Further, certain non-monetary facts can not be measured.

(v) **No Assurance of Future Performance** An audit is merely an excercise of providing expert opinion on the truthfulness and fairness of financial statements. There is no assurance on the part of the auditor about the future profitability and prospects of the organisation.

(vi) **Detailed Checking Not Possible** In most cases, it is not possible for the auditor to check each and every transaction due to time and cost constraints. He has to rely on test checking. As a result some erors and planned frauds may still remain undetected.

(vii) **Exercise of Judgement** The nature, timing and extent of audit procedures is a matter of professional judgement of the auditor which varies from auditor to auditor. The same

audit work may be done by two auditors in different ways because of differences in personal judgement. As a result there may be significant difference in the quality of the work done.

(viii) **Influence of Management on the Auditor** There are also instances that the auditor is influenced by the management.

(ix) **Post-mortem Activity** Critics argue that it is not useful because it starts only after the events have taken place. As a result losses can hardly be prevented.

## 1.3 PRINCIPLES GOVERNING AN AUDIT

The basic principles governing an audit are stated below:

(i) **Integrity, Objectivity and Independence** The auditor has to be straightforward, fair, impartial, honest and sincere in his approach to professional work.

(ii) **Confidentiality** The auditor should uphold the privacy of the information and should not disclose any such information to a third party, including the employees of the entity, without the explicit authority of the management or client or unless there is a lawful or a professional responsibility to do so.

(iii) **Professional Care, Skill and Competence** The auditor should exercise due professional care, competence and diligence expected of him while carrying out the audit work.

(iv) **Responsibility of Work Performed by Others** The auditor should carefully direct, oversee and review the work delegated to staff. Likewise, the auditor may also use the work done by other auditors or experts.

(v) **Documentation** The auditor should document matters, which are essential in providing evidence that the audit was carried out in accordance with the standards.

(vi) **Planning** The auditor should plan his work in such a way as to enable him to conduct an audit in a timely and efficient manner. The audit plan should be based on the knowledge of the business of the entity. The plan should be continuously reviewed and modifications should be incorporated, if required.

(vii) **Audit Evidence** The auditor should get hold of enough suitable evidence to enable him to draw reasonable conclusions therefrom.

(viii) **Accounting System and Internal Control** The auditor should have an understanding of the internal control and risk management framework established by the management. He has to judge the adequacy of such framework as well.

(ix) **Audit Conclusions and Audit Report** The auditor should review and measure the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report. Nevertheless, in case the auditor comes across any actual or suspected fraud, it would be more apt for him to bring the same instantaneously to the notice of the management.

## 1.4 AUDITING AND OTHER FIELDS OF KNOWLEDGE

### 1.4.1 Auditing and Accounting

The basic objective of accounting is to record all the economic events that change the financial position of the entity and to prepare a statement of performance and a statement of affairs for each accounting period. On the other hand, auditing and more specifically financial auditing is undertaken to appraise the authenticity and reliability of the of the accounting records and other relevant documents in order to arrive at a conclusive opinion as to whether the financial statements exhibit a true and fair view of the financial performance and state of affairs of the organisation. Thus auditing is basically a technique of accounting control which, in its conduct, aims to detect all material misstatements and frauds and thereby put a check on the accountants and management.

Auditing is the critical aspect of accounting and hence can never be considered to substitute the latter. In this context, the following differences between accounting and auditing can be mentioned.

| S.No. | Points of Difference | Accounting | Auditing |
|---|---|---|---|
| 1. | **Scope** | Accounting is mainly concerned with the preparation of financial statements. | Auditing is a systematic and independent examination of data, statements, records, operations and performance (financial and otherwise) of an enterprise for a stated purpose. |
| 2. | **Status** | An accountant is an employee of the organisation. | An auditor (other than the internal auditor) is an independent outsider. |
| 3. | **Service tenure** | An accountant is a permanent employee of the organisation. | An auditor is generally appointed for one year. |
| 4. | **Formal qualification** | A formal qualification is not essential for an accountant. | A formal qualification is a must for a company auditor. |
| 5. | **Knowledge in other areas** | An accountant is not expected to have knowledge in auditing or in other areas. | Apart from thorough knowledge in accounting, an auditor should have knowledge in other disciplines like law, management, economics, etc. |
| 6. | **Report submission** | An accountant is not required to submit any report. | An auditor has to submit a report to his appointing authority expressing his opinion on the truthfulness and fairness of the financial statements. |
| 7. | **Remuneration** | As an employee of business, an accountant draws his monthly salary regularly. | An auditor is paid a remuneration agreed upon between him and his client. |
| 8. | **Nature of work** | The work of an accountant is constructive in nature. | The work of an auditor is analytical in nature. |

### 1.4.2 Auditing and Law

Examining evidence is key to both auditing and law. The auditor comments on the accuracy and reliability of the financial statements on the basis of evaluation of the evidence. Likewise, in legal matters, judgement is passed after careful examination of evidence, both actual and circumstantial. As such, an auditor is required to possess sound knowledge about legal affairs especially in the areas of Companies Act, Income Tax Act and relevant laws of indirect taxes to perform his duty properly.

### 1.4.3 Auditing and Statistics

The relationship between auditing and statistics is close in the sense that in today's world the auditor has to apply many statistical tools, techniques and procedures for successful completion of audit work. In large organisations, the auditor has to apply 'test checking' in lieu of detailed checking. The concept of test checking is based on the statistical concept of 'sampling'. Statistical tools are also needed to evaluate the sickness of organisations. Further, statistical tools like correlation analysis, regression analysis, trend analysis, etc. are very much essential for analytical review.

### 1.4.4 Auditing and Information Technology

The presence of information technology is greatly felt in the domain of accounting. The system of manual accounting has been replaced by the system of computerised accounting in most parts of the world. Further, computer-aided audit techniques have been developed and used by many organisations. In such circumstances, it is of utmost importance that the auditor should be familiar with the latest accounting software and sophisticated computer-aided audit techniques to perform his duties in an efficient manner.

### 1.4.5 Auditing and Economics

Economic factors greatly affect the business activities both at the national and international level. Some significant economic factors which have a greater impact on the activities of business organisations are economic policy of the government, fluctuation in exchange rate, etc. An auditor should be conversant with the economic environment of the nation and that of the globe as well to carry out his audit work. As such, it can be said that the relationship between auditing and economics is very close.

### 1.4.6 Auditing and Management

Auditing is closely connected with various fields of management, particularly financial management and operation management. In most organisations decisions are taken based on their financial implications. Moreover, organisations often procure funds through various financial instruments and also invest their surplus funds in different financial products. As a result knowledge of financial techniques as well as financial market and instruments is imperative for an auditor while appraising such transactions. Similarly, knowledge of operations

management is also likely to help the auditor to properly understand the complex operations of the organisation and thereby to decide the scope of his audit work.

## 1.5 AUDITING AS A SOCIAL SCIENCE

The term "social science" refers to any scholastic discipline that focuses on the disciplined and systematic study of society, investigates problems of human society and renders direct or indirect services to the society. Social science covers a broad range of disciplines. Examples of social science are anthropology, sociology, economics, psychology and political science etc. All these subjects or branches of knowledge systematically study the society and its problems and attempt to devise various principles to overcome such problems. Likewise auditing also systematically studies the operations of a business or any other entity which is basically a part of the society. Auditor's comment on the accuracy and reliability of the financial statements of a business entity is of immense value to all stakeholders associated with that entity. Auditing has its social objects like protecting the interest of investors, shareholders, labourers and consumers, preventing capital erosion and to stop tax evasion in national interest. These are likely to have direct or indirect positive impact on the societal wellbeing. Thus auditing can rightly be called a social science

Moreover, social science is 'dynamic' and evolves with the passage of time by accommodating required changes. Auditing is also dynamic and modifies itself in response to the changes in law or regulations and stakeholders' expectations. Historical evidences indicate that accounting and auditing existed even in ancient Greece, Rome, Egypt and India. However, the scope of audit was very limited in that period. In eighteenth century industrial revolution in England led to the development of corporate form of organisations. Management got separated from ownership and volume of transactions increased enormously. As a result auditing techniques also started evolving from this phase. Subsequently Companies Act made audit of companies mandatory and professional institutes started issuing rules and regulations for improving the quality of auditing around the globe. All these continuously changed the form, techniques, scope and objectives of auditing profession. Thus the dynamic character of auditing can never be ignored.

Hence, there is no denying the fact that auditing should also be considered as a dynamic social science.

## 1.6 ERRORS AND FRAUDS

### 1.6.1 Error in Accounting

Mistakes committed unintentionally and unknowingly at any stage of accounting are termed as errors. Errors can broadly be classified into five categories viz.

(i) Errors of Commission
(ii) Errors of Omission
(iii) Errors of Duplication

(iv) Compensating Errors
(v) Errors of Principle.

These are discussed below.

**(a) Errors of Commission** Errors arising out of wrong posting (either wholly or partially), wrong totaling, wrong calculations, wrong balancing and wrong carry forward are termed as errors of commission. Some of these errors may affect the trial balance while some others may not.

**Example:**

(i) Purchase of goods for ₹10000 may be entered as ₹1000 in the Purchase Day Book. This error will not affect the trial balance.
(ii) Purchase of goods for ₹10000 posted to the debit side of supplier's account. This error will not affect the trial balance.

**(b) Errors of Omission** Such errors arise when transactions are not recorded either wholly or partly in the books of accounts. Full omission takes place if a transaction is not at all recorded in the books of original entry.

**Example:** Goods sold to Mr. X for ₹10000 were not recorded in the Sales Day Book at all. On the other hand partial omission occurs when a transaction is recorded partially.

**Example:** Goods sold to Mr. X for ₹10000 was not posted to Mr. X A/C.

Error due to full omission will not affect the trial balance and hence is difficult to detect. On the other hand, errors due to partial omission will affect the trial balance and can be detected easily.

**(c) Errors of Duplication** Such errors arise because of double recording of the same transaction. Double posting of a transaction from journal to ledger create such errors as well.

**Example:**

(i) Goods sold to Mr.X have been recorded twice in the primary books. This error will not affect the trial balance.
(ii) Goods sold to Mr.X have been posted twice in the account of Mr. X. This error will affect the trial balance.

**(d) Compensating Errors** When two errors are committed in such a way that effect of one gets offset by another, they are known as compensating errors.

**Example:** Peter's account which was to be debited for ₹10000 was debited for ₹1000 and similarly, John's Account which was to be credited for ₹10000 was credited by ₹1000. These two errors nullify the effect of each other. Hence they are compensating error.

**(e) Errors of Principle** Such errors take place when, at the time of recording a transaction, the fundamental principles of accounting are not properly followed. Incorrect allocation

of expenditure between capital and revenue, incorrect presentation of items in financial statements are some of the reasons for such errors.

**Example:** Wages paid on installation of Machinery wrongly debited to Wages Account.

This type of errors occurs due to lack of knowledge of sound principles of accounting or can even be committed purposely to forge the accounts. In order to detect such errors, the auditor has to carry out a vigilant inspection of the books of account.

### 1.6.2 Fraud

The term 'fraud' refers to intentional misstatement or misappropriation and essentially involves deception for the purpose of obtaining any illegitimate advantage. It is an intentional false representation with some mischievous objectives.

As per SA-240 on 'The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements', fraud refers to an intentional act by one or more individuals among management, those charged with governance or third parties, involving the use of deception to obtain an unjust or illegal advantage.

### Classification of Fraud

SA-240 has classified frauds in the following way:

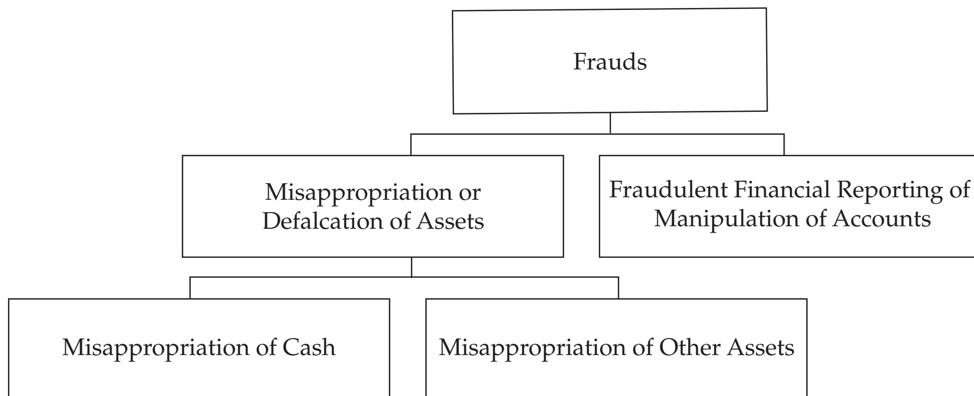


**Fig. 1.1**

These are discussed below.

#### I. Misappropriation of Assets

It refers to theft or embezzlement of an entity's assets like cash or goods and is often perpetrated by employees in relatively small concerns. However, it may also involve the management who is in a better position to conceal such misappropriation in ways that are difficult to detect. Misappropriation is further divided as follows:

***A. Misappropriation of Cash***

In an entity, cash may be misappropriated in the following ways –

(a) Embezzling receipts, for example – misappropriating collection from customers, diverting bad debt recovery to personal accounts.
(b) Recording payments to fictitious accounts, for example – payments to fictitious suppliers, payments to fictitious employees, recording fictitious expenses.

***B. Misappropriation of Other Assets***

In an entity, assets other than cash may also be misappropriated. Some of the instances are –

(a) Stealing physical assets, for example – stealing inventory from store, stealing scrap for resale etc.
(b) Stealing intellectual property, for example – disclosing technological secrets to competitors for personal gain.
(c) Using entity's assets for personal use, for example – using entity's assets as collateral for personal loan.

### II. Fraudulent Financial Reporting or Manipulation of Accounts

It involves intentional misstatements including omission of transaction or disclosures in financial statements to defraud the users of financial statements. Very often it is done by the management team itself in order to manage earnings and thereby to influence the perceptions of the decision makers as regards to entity's performance and profitability. The motives behind such manipulation include maximisation of performance based compensation, meeting expectations of owners, disregard the claims of the employees to increase wages, evading taxes, securing loans at favourable terms etc.

Fraudulent financial reporting can be accomplished in three ways –

(a) Manipulation, falsification or alteration of accounting records or supporting evidences, for example – concealing facts that could affect the numbers recoded in the financial statements, altering records of transactions.
(b) Misrepresentation in or omission from financial statements of events, transaction or other relevant information, for example – omitting, delaying or advancing recognition of transactions and events in the financial statements.
(c) Misapplication of accounting principles relating to classification, estimation, presentation and disclosure. For example – inappropriately changing assumptions and judgements used to estimate account balances.

## 1.6.3 Difference between Error and Fraud

The differences between error and fraud are presented below:

| S.No. | Points of Difference | Error | Fraud |
|---|---|---|---|
| 1. | **Intention** | It is unintentional. | It is intentional. |
| 2. | **Impact** | The impact of the error on the organisation is generally not serious. | The impact of fraud on the organisation is usually very serious. It can damage the goodwill of the organisation. |
| 3. | **Involvement** | Lower level employees are usually involved in an error. | Higher or lower level employees are involved in fraud. |
| 4. | **Liability** | It results in civil liability. | It leads to criminal liability. |
| 5. | **Type** | Errors are of two types: (1) Clerical Errors and (2) Errors of Principle. | Fraud may be of two types: (1) Misappropriation and (2) Manipulation or falsification of accounts. |
| 6. | **Integrity** | Error doesn't generally raise questions about the integrity of the concerned person. | In the case of fraud, the honesty and integrity of the concerned individual is always in doubt. |

## 1.6.4 Teeming and Lading

It is a method of misappropriation of cash by which the past defalcations are covered up by the current receipts. It is also known as 'lapping' or 'delayed accounting'. In this method the cashier or the person who handles the cash of the organisation uses the money received from a person for his personal purpose for some time and when another payment comes to him he deposits that money against first money used without showing the new amount received. This process continues until the time the original amount misappropriated is replaced or the cashier is caught. Teeming and lading is common in organisations where number of cash transactions is many. The transactions those are susceptible to teeming and lading are (a) collection from customers, (b) payment to suppliers, (c) deposit of daily cash collections in bank account and (d) daily cash expenses.

Teeming and Lading can often be detected with the help of auditors. However, for this purpose the auditor has to carefully examine the internal check system regarding cash. If there is any deficiency in the internal check system, he must probe into the matter.

## 1.6.5 Auditor's Duty Regarding Errors and Frauds

The duties of an auditor in relation to errors and frauds are largely determined by the available legal decisions and professional promulgations.

### A. Legal Decisions

Auditor's duty in detecting and preventing errors and frauds has been recognised in a number of legal decisions. In London vs. General Bank (1895) case, it was held that an auditor must exercise reasonable care and skill in conducting his audit work. However, he is not an insurer and never guarantees that the books of accounts are free from errors. Hence if any such error

remains undetected even after conducting the audit with reasonable skill and care, the auditor cannot be held liable. In Kingston Cotton Mills Co. (1896) case also it was held that 'an auditor is a watch dog and not a blood-hound'. Hence if there is anything suspicious, the auditor must look into such matters thoroughly, but in absence of any such suspicious matters, he shall be relieved of his liability if it is proved that he has exercised reasonable skill and care in performing his job.

Detection of frauds and errors is not the primary responsibility of the auditor. However, in the course of audit, he must be alert to all such possibilities. But, if the errors and frauds are not detected even after careful conduct of audit, the auditor should not be held liable for such not detection.

As regards to the prevention of errors and frauds the auditor does not have any direct responsibility. He can only act as an advisor to the management in this issue.

**B. Professional Promulgation**

SA-240 on 'The Auditor's Responsibility related to Fraud in an Audit of Financial Statements' contains detail previsions regarding the duty of an auditor in detection and prevention of errors and frauds. The summary of these provisions are given below:

(a) The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

(b) The auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

(c) The auditor shall maintain an attitude of professional skepticism throughout the audit. He should be alert to any possibility of material misstatements.

(d) The auditor should identify fraud risk factors i.e. events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

(e) If he has any doubt as to the authenticity of any document, he shall enquire into the matter.

(f) He shall hold discussion with the audit engagement team on how and where the entity's financial statements may be susceptible to material misstatement due to fraud.

(g) He shall evaluate the effectiveness of internal control system.

(h) He may design and perform further audit procedure based on his assessed risk of material misstatement.

(i) In case the auditor finds any material misstatement he shall evaluate whether such misstatement is an indicator of fraud.

(j) He shall communicate all errors and frauds identified during audit to the management and shall ask proper explanation from the management.

(k) In case of minor misstatements, he shall ask the management to rectify the same immediately.

(l) In case he faces any resistance from the management and is unable to continue his work, he will withdraw his engagement and shall inform the regulatory authorities about the same.

(m) He shall submit qualified or adverse report in case the misstatement is so severe that it materially affected the true and fair view of the financial performance and state of affairs of the entity.

## 1.7 CLASSIFICATION OF AUDITING

In the commercial world, nature and type of businesses are not similar. The auditing carried out in those organisation are not uniform. The scope and timing of audit may also vary. Therefore different basis may be followed in classifying audits. There are (i) objective-wise classification of audit, (ii) periodicity-wise classification of audit, (iii) technique-wise classification of audit, (iv) coverage-wise classification of audit, (v) organisational structure-wise classification of audit and subject mater-wise classification of audit.

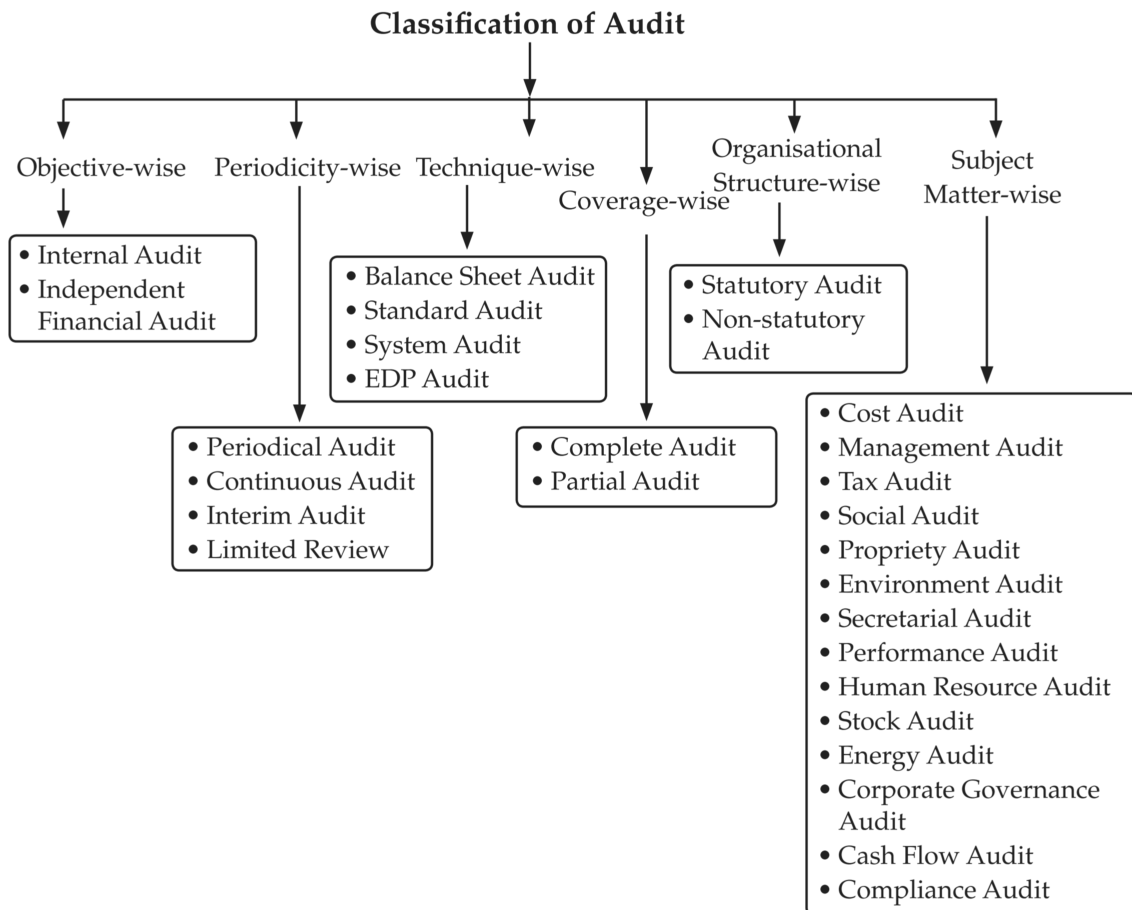


**Fig. 1.2**

These are discussed below:

## 1.7.1 Objective-wise Classification of Audit

### A. Internal Audit

Internal audit refers to an independent appraisal exercise within an entity by its own staff or any independent professional appointed for this purpose in order to review the accounting, financial and other operations and contracts within an organisation as a service to the organisation.

According to the institute of Internal Auditors, New York, "Internal audit is an independent appraisal activity within the organisation for the review of financial, accounting and other operations done as a basis of service to the management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls".

According to Prof. Walter B. Meigs, "Internal auditing consists of a continuous, critical review of financial and operating activities by a staff of auditors functioning as full time salaried employees."

Internal audit furnishes the appraisals, analysis, suggestion and information based on their review to the management in order to facilitate effective control at a reasonable cost.

***Objectives of Internal Audit***

The objectives of internal audit are:

(a) To suggest improvements to the functioning of the entity;
(b) To strengthen the overall governance mechanism of the entity, including its strategic risk management as well as internal control system,
(c) To comment on the effectiveness of the internal check system in force and to suggest ways and means for improving such system,
(d) To facilitate early detection and prevention of errors and frauds.

***Features of Internal Audit***

Internal audit has the following characteristics –

**(a) Independent Department** In an organisation internal audit department comprises of qualified personnel and acts as an independent department.

**(b) Offers Suggestions** The main aim of internal audit if to offer suggestions for improvement of the functionality of the internal control system.

**(c) Accountable to Superiors** An internal auditor is always accountable to its appointing authority i.e. the management of the entity.

**(d) Part of the Internal Control** Internal audit is a part of the internal control system of the organisation.

**(e) Legal Compulsion** As per Section 138 of Companies Act, 2013, internal audit is mandatory for companies belonging to the class notified by the Central Govt.

**Note:** For detail discussion on Internal Audit, students may follow Chapter 3 of this book.

### B. Independent Financial Audit

An independent financial audit is an independent, objective, and systematic evaluation of an organisation's financial statements by professionally qualified outsiders for the purpose of expressing opinion as to the accuracy, reliability, truthfulness and fairness of the financial statements. An independent auditor conducts auditing based on the records and information supplied to them and assertions made by the management and accordingly submits a report on the audit outcome. Such a report is considered to be of high value due to the reason that he is not an employee of the entity and hence cannot be influenced by the management.

Independent financial audit has been made mandatory for organisations that are established by various statutes.

#### *Features of Independent Financial Audit*

(a) **The Auditor** It is conducted by an independent outsider who is professionally qualified and preferably a chartered accountant.

(b) **Objective** The objective of this audit is to give opinion as to the truthfulness and fairness of financial performance and financial position being exhibited by the Profit and Loss Account (or statement) and Balance Sheet.

(c) **Scope** This audit is concerned with vouching of transactions, verification and valuation of assets and compliance with standards and regulations.

(d) **Legal Status** Independent financial audit has been made mandatory for corporations established under any statute.

(e) **Audit Report** The auditor is required to submit his report to his appointing authority only.

## 1.7.2 Periodicity-wise Classification of Audit/Classification of Audit on the Basis of Time

### A. Periodical Audit

**Periodical audit** is one which is taken up at the end of the financial year when financial statements have already been prepared. This is also known as Annual Audit.

According to Spicer and Pegler, 'a final or complete audit is commonly understood to be an audit that is not commenced until the end of the financial period and is then carried on until completed'.

Thus in this form of audit, the auditor visits the client only at the end of the year and then carry on with the audit work of the accounts of the whole year.

#### *Applicability of Periodical Audit*

Periodical audit is suitable in the following cases –

(a) Where number of transactions is limited.

(b) Where internal control system is smooth and effective

(c) Where organisations are not required to prepare interim statements.

***Merits/Advantages of Periodical Audit***

Periodical audit provides following advantages:

1. **Less Expensive** Periodical audit is conducted once in a year and as such the auditor devotes less time and labour. Thus it is less expensive.
2. **No Disturbance in the Client's Work** Periodical audit is conducted only after the finalisation of accounts. Thus there is no unnecessary disturbance in client's normal work flow.
3. **Less Chance to Alter Figure** Since the audit is conducted continuously there is less chance of altering the figures.
4. **Timely Completion of Audit** In case of a well planned periodical audit the audit work can be finished quickly within a reasonable time.
5. **Proper Maintenance of Continuity in Work** In case of periodical audit entire work is done and completed in a continuous session. Thus the possibility of losing the link is less.
6. **Less Monotonous** Under periodical audit the work is completed in one go, the audit staff need not to hang on with the same client for long time. This reduces the monotony in work.
7. **Less Chances of Collusion** Here the audit staff does not meet the employees of the client regularly. Hence there is less chances of collusion between them.

***Demerits/Disadvantages of Periodical Audit***

Followings are the disadvantages of periodical audit:

1. **Unsuitable in Large Organisations** Periodical audit is not suitable for large organisations with numerous transactions.
2. **Possibility of Errors and Frauds Remaining Undetected** Under this method it is not possible to check the books of accounts thoroughly. Therefore it has to rely on test checking. As a result, the chances of some errors and frauds being undetected always exist.
3. **Delay in Making Decisions** It may cause a delay in the declaration of dividends and other critical decisions because audited accounts may not be available immediately after the close of the year.
4. **Post-mortem Activity** Since it is conducted only after the recording and finalizing of all transactions in a year, it is only a post mortem activity hardly having any preventive role.
5. **Delayed Rectification** Since the audit is done only at the end of the accounting period, any error or fraud is detected and corrected after a long time from their occurrence. During this period the concerned person committing the same may enjoy undue advantage.

6. **No Moral Pressure** Under this audit the audit staff does not visit the client's place frequently. As a result there is hardly any moral pressure on the staff of the client's office.
7. **Difficulty in Fixing Audit Programme** Since the auditor may have a number of assignments at the same time, it may be difficult for the auditor to fix audit programme of different clients.

### B. Continuous Audit

It is the form of audit where the audit of accounts takes place throughout the year at regular intervals. This type of audit is essential for large concerns. It is also a must for organisations where the internal control system is found to be weak in certain areas. The work load involved in a continuous audit is significantly high.

#### *Applicability of Continuous Audit*

Continuous Audit is applicable in the following cases:

(i) where final accounts have to be prepared immediately after the close of the financial year.

(ii) where the transactions are many in number.

(iii) where the systems of internal check and internal control in operation are not reasonable.

(iv) where the statements of accounts are to be presented to the management at regular intervals.

(v) where it is necessary to examine the transactions of an organisation in detail.

(vi) where interim dividend is to be declared or interim reports are required to be published.

#### *Advantages of Continuous Audit*

1. **Easy and Early Discovery of Errors and Frauds** Under continuous audit errors and frauds can be discovered early and easily as the accounts are verified in detail at regular intervals by the audit staff.
2. **Valuable Suggestions** Since in a continuous audit the auditor is in constant touch with the business, he is in a better position to make valuable suggestions for the improvement of the concern.
3. **Timely Presentations of Accounts** Under continuous audit vouching and verification is performed continuously during the year. Hence the final audited accounts can be prepared soon after the close of the financial year.
4. **Moral Cheek on the Staff** Continuous audit involves regular visit of auditor and audit staff to the client's office. This puts a moral check on the staff in preparing the accounts.
5. **Preparation of Interim Accounts** Continuous audit facilitates preparation of the interim accounts quickly which enables the directors of a company to declare an interim dividend.

6. **Declaration of Final Dividend** Timely preparation of interim accounts facilitates timely finalisation of accounts after the end of the year and timely declaration of final dividends.
7. **Proper Audit Plan** Because of his frequent visit, here it is possible for the auditor to become familiar with the nature of business and system of accounts of the organisation. As a result, he can prepare his audit plan properly which ensures proper allocation of work amongst the audit staff.
8. **Healthy Relationship** There is always a possibility of developing a healthy relationship between the audit staff and the client's staff because here the audit staff visits the organisation frequently. Such a healthy relationship can, many a time, avoid conflict.

***Disadvantages of Continuous Audit***

1. **Chances of Alteration of Figures** In case of continuous audit figures in the books of account which have already been checked by the auditor at his previous visit may be altered by a dishonest clerk to defraud the accounts.
2. **Inconvenience to Client's Work** It may cause inconvenience to the work of the client's staff in the sense that audit work and regular day-to-day work may go on simultaneously at times.
3. **Expensive** It is an expensive system of audit because it involves long time to report and continuous engagement of the auditor.
4. **Possibility of Losing Link** In case there is a lengthy interval between the two visits of the audit staff, the auditor may lose the link between the past and present work.
5. **Chance of Boredom** Under continuous audit, the work of the audit staff becomes mechanical which may cause boredom to them.
6. **Chance of Collusion** The relationship developed between the auditor and the management due to auditor's frequent visit of the client's place, may sometimes lead to collusion between them for some clandestine reason.
7. **Unsuitable for Small Organisation** It is not suitable for the small organisations because it involves substantial amount of cost.

### C. Differences between Continuous Audit and Periodic Audit

Following are the differences between continuous audit and periodic audit:

| S.No. | Points of Difference | Continuous Audit | Periodical Audit |
|---|---|---|---|
| 1. | **Timing** | It is conducted throughout the year. | It is conducted after the preparation of financial statements. |
| 2. | **Cost** | It is more costly. | It is less costly. |

(Contd.)

| | | | |
|---|---|---|---|
| 3. | **Detection of error and fraud** | Here early detection of error and fraud is possible and accordingly appropriate measures can be taken to prevent their recurrence. | Early detection of error and fraud is not possible here because it is carried out after the preparation of final accounts. |
| 4. | **Reliability** | It is more reliable. | It is less reliable. |
| 5. | **Scope** | Detailed checking is possible. | Detailed checking is not possible. |
| 6. | **Monotony** | The possibility of monotony can't be ruled out. | It doesn't give rise to monotony. |
| 7. | **Collusion** | There is a possibility of collusion between audit staff and employees of the organisation. | There is hardly any possibility of collusion between audit staff and employees of the organisation. |
| 8. | **Interim dividend** | It facilitates declaration of interim dividend. | It doesn't facilitate declaration of interim dividend. |
| 9. | **Moral pressure** | Moral pressure on the employees of the organisation is there as the audit staff frequently visit the organisation. | There will be less moral pressure on the employees of the organisation because the audit staff visit the organisation at the end of the year. |
| 10. | **Applicability** | It is suitable for large organisations. | It is suitable for all organisations. |
| 11. | **Report** | It facilitates timely submission of the audit report. | It takes time to prepare and submit the audit report under periodical audit. |
| 12. | **Audit programme** | Audit programme can be prepared easily because the auditor has familiarity with the nature of business and system of accounts of the organisation. | Preparation of audit programme is not that easy since it takes time for the auditor to become familiar with the nature of business and system of accounts of the organisation. |

### D. Interim Audit

It is an audit which is conducted in between the two periodical or balance sheet audits with a view to find out interim profits in order to enable the company to declare an interim dividend. The purpose is to minimise the work and time involved in concluding the audit after the fiscal year. It may be conducted monthly, quarterly or half yearly.

#### *Objectives of Interim Audit*

The objectives of interim audit are as follows:

1. **Ascertainment of Interim Profit and Loss** One of the important objectives of interim audit is to ascertain the profit or loss of the interim period.
2. **Declaration of Interim Dividend** By finalizing the interim reports, interim audit also helps the management to make decision on interim dividend.
3. **Obtaining Loan** Lenders often require audited interim accounts to sanction loan.

4. **Information on Interim Financial Position** Another important objective of interim audit is to acquire information about the financial position of interim phase.
5. **Conducting Investigation** To conduct an investigation on specific issues on behalf of the owners, directors or government on special situations is an important objective of interim audit.
6. **Valuation of Goodwill** One of the purposes of interim audit is to determine the value of goodwill of an organisation, especially in a situation where an acquisition offer is under consideration.

***Advantages of Interim Audit***

1. **Publication of Interim Figures** Interim audit is very useful in cases where publication of interim figures is essential.
2. **Timely Detection of Errors** Interim audit facilitates detection of errors and frauds in time and thereby ensures prompt corrective actions without allowing them to cause much harm.
3. **Moral Check** Interim audit puts a moral check on the employees of the client. This reduces the chance of frauds considerably.
4. **Early Completion of Final Audit** Interim audit ensures early completion of final audit.
5. **Interim Dividend** Interim audit is very useful in case the company decides to declare interim dividend.
6. **Important for Partnership Firms** In the case of admission of a new partner or in the event of retirement or death of an existing partner, interim audit is very helpful in determining the position of assets and liabilities.
7. **Helps in Obtaining Loan** Financial institutions often ask for interim audited accounts before sanctioning loans.

***Disadvantages of Interim Audit***

1. **Disturbance in Office Work** Interim audit may interrupt the normal work flow in the accounts department.
2. **More Expensive** Interim audit is not a substitute of final audit. Thus it creates extra cost burden on the business.
3. **Possibility of Alteration of Figures** Accounting figures may be altered after interim audit.

### E. Limited Review

As per **Clause 41 of the Listing Agreement of the Securities and Exchange Board of India (SEBI),** the company shall submit its quarterly, year to date and annual financial results to the stock exchange in the manner prescribed in this clause. The company has an option either to

submit audited or unaudited quarterly and year to date financial results to the stock exchange within forty-five days from the end of each quarter (other than the last quarter), subject to the following:

1. In case the issuer opts to submit unaudited financial results, they shall be subjected to limited review by the statutory auditors of the issuer (or in case of public sector undertakings, by any practising Chartered Accountant) and such **limited reviewed results** (financial results accompanied by the limited review report) shall be submitted within forty-five days from the end of the quarter.
2. In case the company opts to submit audited financial results, they shall be accompanied by the audit report.

   As the name suggests, the scope of limited review is narrower than the scope of an audit. In limited review procedures, generally accepted auditing standards are not always strictly adhered to.

   As per **Standard on Review Engagements (SRE) 2400**, a limited review engagement provides a moderate level of assurance that the information subject to review is free of material misstatement. This is expressed in the form of negative assurance.

Procedures for the review of financial statements will ordinarily include the following:

1. Obtaining an understanding of the entity's business and the industry in which it operates.
2. Inquiries concerning the entity's accounting principles and practices.
3. Inquiries concerning the entity's procedures for recording, classifying and summarising transactions, accumulating information for disclosure in the financial statements and preparing financial statements.
4. Inquiries concerning all material assertions in the financial statements.
5. Analytical procedures designed to identify relationships and individual items that appear unusual. Such procedures would include:
   (a) Comparison of the financial statements with statements for prior periods.
   (b) Comparison of the financial statements with anticipated results and financial position.
   (c) Study of the relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience or industry norm.

   In applying these procedures, the practitioner would consider the types of matters that required accounting adjustments in prior periods.
6. Inquiries concerning actions taken at meetings of shareholders, the board of directors, committees of the board of directors and other meetings that may affect the financial statements.

7. Reading the financial statements to consider, on the basis of information coming to the practitioner's attention, whether the financial statements appear to conform with the basis of accounting indicated.
8. Obtaining reports from other practitioners, if any and if considered necessary, who have been engaged to audit or review the financial statements of components of the entity.
9. Inquiries of persons having responsibility for financial and accounting matters concerning, for example:
   (a) Whether all transactions have been recorded.
   (b) Whether the financial statements have been prepared in accordance with the basis of accounting indicated.
   (c) Changes in the entity's business activities and accounting principles and practices.
   (d) Matters as to which questions have arisen in the course of applying the foregoing procedures.
   (e) Obtaining written representations from management when considered appropriate.

### 1.7.3 Technique-wise Classification of Audit

#### A. Balance Sheet Audit

A **balance sheet audit** is an appraisal of the correctness of all information found in the balance sheet of an organisation. It includes verification of items included in the balance sheet along with the inspection of related income and expenses accounts. (Balance sheet audit requires looking at more than the financial statement itself). It starts from the balance sheet and goes back to the books of primary entry and supporting evidences in order to validate each and every piece of information of the balance sheet.

***Features of Balance Sheet Audit***

Balance sheet audit shares the following characteristics:

(a) The examination under balance sheet audit is limited to all the items of balance sheet and only those items of profit and loss account that have direct influence on balance sheet.

(b) Balance sheet audit follows a top-down approach unlike the bottom-up approach under conventional auditing.

(c) Instead of test checking it applies detail checking.

(d) Here profit is viewed as the change in net assets between two balance sheet dates subject to the adjustment of introduction and withdrawal of capital.

(e) Effective application of balance sheet audit largely depends on an efficient internal control system.

#### *Applicability of Balance Sheet Audit*

In large organisations, transactions are plentiful and predominantly they are computerised. In such cases, the routine checking may be wholly dispensed with. Moreover, if the computerised accounting system is tied with efficient internal control, exhaustive vouching can also be dispensed with. In those organisations, balance sheet audit is really useful.

#### *Objectives of Conducting Balance Sheet Audit*

The objectives of balance sheet audit include the following:

1. To make sure that all assets are included in the balance sheet at their proper value.
2. To ensure that all liabilities are incorporated at their proper value.
3. To make certain that the assets shown in the balance sheet are in fact owned by the organisation.
4. To substantiate that all items are properly recognised into capital items and revenue items and treated accordingly.
5. To make sure that established accounting principles are followed to prepare the balance sheet.
6. To ensure that the requirements of relevant Statutes are suitably complied with.

### B. Standard Audit

The term '**standard audit**' signifies detailed examination of certain material or significant items and application of appropriate test checks on the remaining items on the basis of auditing standards provided there exists an adequate internal check system.

#### *Advantages of Standard Audit*

1. Audit programmes under standard audit are suitably designed based on the auditing standards.
2. Audit approach and techniques to be followed are suggested by the audit pronouncements.
3. Since the audit procedures are fully guided by the audit standards, there is no scope of any collusion between the auditor and client's staff.

#### *Disadvantages of Standard Audit*

1. Since under standard audit test checking is performed on a section of accounts, some errors and frauds may remain undetected.
2. Following standards may largely eliminate the scope of creativity in audit planning.
3. Standards must be regularly developed to suit the changing business environment.

### C. System Audit

A system audit is a form of audit which examines the adequacy and effectiveness of the prevailing accounting system of the organisation and enables the authority to take appropriate measures for designing a proper accounting system if the existing system of accounts is found to be ineffective.

Accounting system of the organisation must change in response to the changes in the socio-economic environment and regulatory requirements. Thus organisations often appoint system auditor to review whether the existing system of accounting is up to date, cost effective and sufficient to produce all information required by the internal and external stakeholders. It necessitates periodic review and appraisal of the existing accounting system.

***Advantages of System Audit***

1. System audit suggest for necessary changes in accounting system to make it more useful and relevant.
2. It ensures generation of all information required by the stakeholders by suggesting revision of existing system
3. System audit prevents recurrence of errors and frauds due to inefficiently in accounting system.
4. It is dynamic and hence keeps the accounting system up to date.

***Disadvantages of System Audit***

1. System audit is a costly affair.
2. An organisation may face resistance from the accounting staff in changing the accounting system following the suggestion of system auditor.

#### D. EDP Audit

**EDP audit** is an analysis of an organisation's computer and information systems in order to evaluate the reliability of its production systems as well as likely security cracks. It is the audit of all information system assets, to make sure that they are sufficiently secured against vulnerabilities of natural and man-made disasters and works best to safeguard the assets, generate data on time and maintain integrity of data. Such audit is carried out by qualified information system auditors.

EDP audit helps the auditor to generate reports in specific format which can be of great help to the auditor. Moreover, since in under computerised environment chances of clerical errors are minimised, the statutory auditor can considerably cut down the scope of the audit in case the EDP audit reports are satisfactory.

However, there are certain limitations of EDP audit. Possibility of hacking can make the computer system and accounting data vulnerable. There may also be situations where the auditor fails to establish audit trail (i.e. to trace individual transactions from their source to completion) due to non-existence of input documents.

### 1.7.4 Coverage-wise Classification of Audit

#### A. Complete Audit

Complete audit implies meticulous examination and verification of an organisation's financial and accounting records, internal controls that are deemed to be all-inclusive or relatively

comprehensive depending on the size of the company being audited. Such audits are more reliable for the portions audited because complete audits will include the audit of subsidiary documents and records as well as supporting documents. Thus under complete audit no item of transactions will remain unchecked and hence authenticity of records and reports is the maximum.

#### *Advantages of Complete Audit*

1. **Chances of Errors and Frauds are Negligible** In case of complete audit all transactions are examined. As a result chances of errors and frauds are negligible.
2. **Moral Pressure on Employees** Since all items of the records are extensively examined, employees cannot escape any wrongdoing whatsoever. Thus they always remain under moral pressure.
3. **Suitable for Small Concern** This form of audit is very suitable for small concerns with limited number of transactions.
4. **More Reliable Audit Report** Under complete audit the audit report is based on thorough examination of all items. As a result it is more reliable.

#### *Disadvantages of Complete Audit*

1. **Time Consuming** This form of audit is too much time consuming.
2. **Delayed Publication of Audited Accounts** In case of complete audit, often, the publication of audited accounts is delayed considerably.
3. **Not Suitable for Large Concerns** This form of audit is not practicable for large organisations.

### B. Partial Audit

Partial audit refers to the form of audit which is conducted based on some specific records or any specific part of the books of accounts either for the whole or any part of the accounting year. Thus it is purpose specific and hence is limited in its scope. By and large, business transactions are related to cash, debtor, creditor, stock etc. An organisation may decide to conduct an audit of any of these transactions.

Under partial audit, an auditor should conduct audit of only such transactions that are specifically stated in the agreement. Similarly the auditor must sign the report clearing stating that the audit is 'partial audit'. If it is stated, then he will not be accountable for any loss which is caused due to using the report as the complete audit report.

#### *Advantages of Partial Audit*

Partial audit has following advantages:

(i) **Cost-effective** It is less expensive because the audit is conducted on suspected areas only.

(ii) **Early Detection of Frauds and Errors** Partial audit helps in detecting the frauds and errors quickly.

(iii) **Enhancing Efficiency** Partial audit provides useful suggestions which increase the efficiency of staff.

***Disadvantages of Partial Audit***

Partial audit has following disadvantages:

(i) **No legal sanction:** It is not a statutory audit.

(ii) **Emphasising control only:** It is usually carried out only for control purpose.

### 1.7.5 Organisation Structure-wise Classification of Audit

#### A. Statutory Audit

An audit which is undertaken under any specific statute or Act is called 'statutory audit'. The term 'statutory' signifies anything regulated by laws of the state. Accordingly, a statutory audit is the official inspection of an organisation's books of accounts by an independent body as per the requirements of a statute. The objective of this audit is to ensure fair and accurate representation of the financial statements of an entity.

The forms of organisations for which audit is mandatory in India under any statute are as follows:

| Statutory Audit is Applicable for | Relevant Statute |
|---|---|
| Joint Stock Companies | Companies Act, 2013 |
| Banking Companies | Banking Regulations Act, 1949 |
| Electricity Companies | Electric Supply Act, 1948 |
| Co-operative Societies | Co-operative Societies Act, 1912 |
| Trusts | Respective State Acts |

#### B. Non-statutory Audit

A non-statutory audit is such an audit which is not required by either the law or any regulatory authority. They are usually carried out at the will of an organisation or in some cases to adhere to the internal policies of the organisation. This audit is often used by sole proprietors, limited and unlimited liability partnerships, associations, clubs, charitable trusts etc. in order to enhance their reliability.

It is to be noted in this context that though there is no statutory requirement, the auditor may still be held responsible under the natural law of the land. Moreover the auditor must document the terms of his appointment in form of an engagement letter which shall specifically indicate the scope of the audit.

***Students' Tutorial***

Though in case sole proprietors and limited and unlimited liability partnerships, audit is not required by any Act of their origin, if any, as per the Income Tax Act 1961, audit is compulsory u/s 44AB for various organisations as follows:

(a) For sole proprietorship business with turnover exceeding ₹1 crore.
(b) For sole professionals with earnings exceeding ₹25 lakh.
(c) For partnership firm of business with turnover exceeding ₹100 lakh.
(d) For partnership firm in profession with earnings exceeding ₹25 lakh.

## C. Differences between Internal Audit and Statutory Audit

Following are the differences between internal audit and statutory audit:

| S.No. | Points of Difference | Internal Audit | Statutory Audit |
|---|---|---|---|
| 1. | **Legal Requirement** | Internal audit is the need of management, but it is not always compulsory by law. | Statutory audit is the legal requirement. |
| 2. | **Qualification** | An internal auditor does not require specific qualification as per the provision of law | The qualification of a statutory auditor is specified in the statute. |
| 3. | **Status** | An internal auditor is generally a staff who is appointed by the management. | A statutory auditor is an independent person appointed usually by the shareholders. |
| 4. | **Report** | Internal auditor needs to give suggestions to improve weakness but does not need to present the report. | A statutory auditor has to prepare the 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. Giving recommendations is not a part of his duty. |
| 5. | **Appointment and removal** | An internal auditor is appointed by the management. Similarly, he can be removed from his post by the management without legal formalities. | In the case of company form of business, the statutory auditor is appointed by the shareholders (in most cases), or by the board of directors, or by the Central Government. Removal of the statutory auditor is governed by the provisions incorporated in the concerned statute. |
| 6. | **Duties and Liabilities** | Duties and liabilities of an internal auditor are determined by the management. | Duties and liabilities of the statutory auditor are specifically incorporated in the concerned statute. |
| 7. | **Scope** | It may be a complete audit or partial audit as per the decision of the management. | It must cover all the aspects as stated in the concerned statute. |

### D. Differences between Statutory Audit and Non-statutory Audit

| S.No. | Points of Difference | Statutory Audit | Non-statutory Audit |
|---|---|---|---|
| 1. | **Legal compulsion** | It is compulsory under statute or law. | It is not mandatory. Rather it is optional. |
| 2. | **Nature** | It must cover all the aspects as stated in the concerned statute. | It may be a complete audit or partial audit as per the decision of the appointing authority. |
| 3. | **Qualification** | A statutory auditor must possess the requisite qualification as per the concerned statute. | No specific qualification is prescribed for non-statutory auditor. |
| 4. | **Example** | Audit of companies, banks, cooperative societies, trusts, etc. are examples of statutory audit. | Audit of a sole proprietorship, partnership, firms, clubs, associations etc. are examples of non-statutory audit. |
| 5. | **Appointment** | In the case of company form of business, the auditor is appointed by the shareholders (in most cases), or by the board of directors, or by the Central Government. | In the case of sole proprietorship business, the auditor is appointed by the sole proprietor. In the case of partnership firms, the auditor is appointed by the partners. |
| 6. | **Remuneration** | Remuneration of a statutory auditor is fixed according to the provisions of the concerned statute. | Remuneration of a non-statutory auditor is fixed on the basis of agreements entered into between the auditor and his appointing authority. |
| 7. | **Rights and duties** | Rights and duties of a statutory auditor are governed according to the provisions of the concerned statute. | Rights and duties of a non-statutory auditor are determined on the basis of agreements entered into between the auditor and his appointing authority. |
| 8. | **Liability** | Liabilities of a statutory auditor are two-fold: (a) Liabilities as per the concerned statute and (b) Liabilities under the common law of the country. | A non-statutory auditor can be held liable only under the common law of the country. |

## 1.7.6 Subject Matter Wise Classification

Following are the recent trends in the field of auditing.

### A. Cost Audit

Cost Audit involves an examination of cost books, cost accounts, cost statements and subsidiary and prime documents with a view to satisfying the auditor that these represent true and fair view of the cost of production. This includes the examination of the appropriateness of Cost Accounting system.

The Institute of Cost Accountants of India on the other hand, defines cost audit as "a system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries."

The need for audit of cost accounts is now being growingly felt in industry. It has got vast potentiality particularly in the context of wastage and inefficiency, underutilisation of capacity, low productivity, corporate sickness, rising price and slow pace of economic development. In fact, the thought that the cost audit is superfluous when financial audit is conducted in an organisation, is not at all justified. While financial audit has a great role to play in its respective field, cost audit acts as an effective tool of control in the hands of management. It also renders invaluable services to shareholders, customers, government and to the society at large. (For detail discussion on Cost Audit please refer to Chapter 11).

### B. Management Audit

Management audit refers to an independent and systematic evaluation of all the aspects of management in an organization. It is a critical review of the management process including planning, organizing, coordinating and controlling. Management audit is a forward looking approach. Accordingly, the objective of management audit is to assist the management in effectively discharging their duties by identifying the possible inefficiencies in different levels of management and thereby recommending the possible corrective actions. Thus management audit significantly contributes in improving the efficiency of the management. (For detail discussion on Management Audit please refer to Chapter 11)

### C. Tax Audit

Tax audit can be defined as 'an examination of financial records to assess correctness of calculation of taxable profit, to ensure compliance with provisions of the Income Tax Act and also ensure fulfillment of conditions for claiming deductions under Income Tax Act.' Tax audit is required in addition to the financial audit since taxable income largely differs from accounting profit because of various allowances, disallowances, deductions and exemptions suggested under tax laws.

In India, the Income Tax Act, 1961 has contained a number of provisions requiring tax audit of an entity. Section 44AB gives the provisions relating to the class of taxpayers who are required to get their accounts audited from a chartered accountant. The audit under Section 44AB aims to ascertain the compliance of various provisions of the Income-tax Law and the fulfillment of other requirements of the Income-tax Law. The prime objective of tax audit is to stop tax evasion. (For detail discussion on Tax Audit please refer to Chapter 11).

### D. Social Audit

Business is a social institution and evolves out of social environment. In course of earning profit business takes resources from society, so in return they should discharge certain duties to society also for long term sustainability. In order to measure and examine how far the business concerns have been able to discharge their social responsibility, that is, how much

contribution has been made by the concern towards social welfare, the concept of 'social audit' was introduced in business arena.

Social audit is defined as the system of independent evaluation of operations of an organisation, examination of records relating to social responsibility accounting and critical appraisal of the impact of organisation's on the society.

Social audit is not mandatory in most of the countries including India. This exercise is often undertaken by business houses voluntarily. (For detail discussion on Social Audit please refer to Chapter 11).

### E. Environment Audit

Environment audit is an independent evaluation of policy and principles, systems, procedures, practices and performance, and other elements of a business relating to environment. It is a critical appraisal of the impact of the operations of the organisation on the environment and natural habitat. Moreover, it also examines the compliance with environmental policies, standards and environmental laws. Environment audit helps the management and the regulators to identify the modifications required in their policies and conduct to promote a sustainable environment.

Considering its importance in a country like ours where the awareness on environmental safety, conservation of natural resources is at its minimum, environment audit was introduced way back in 1986 under the Environment Protection Act, 1986. Since then different legislations took care of the need for environmental audit in India by promulgating necessary provisions in this respect. (For detail discussion on Environment Audit please refer to Chapter 11)

### F. Propriety Audit

Propriety audit is the independent and systematic evaluation of the appropriateness of management decisions on the basis of public interest, financial discipline and behavioural standards. In other words, it is an evaluation as to whether decisions have been undertaken in tune with the accepted rules, standards, policy and delegated power. The objective of propriety audit is to ensure safeguard of assets, check misappropriation of funds, misutilisation of delegated authority and increase the productivity of management etc.

In India, propriety audit is not separately practiced. However, the Companies Act, CARO and other legislations contain sufficient provisions that require performance of propriety audit in the context of conventional statutory audit. (For detail discussion on Propriety Audit please refer to Chapter 11)

### G. Performance Audit

The performance/efficiency audit provides the means of appraising the performance of the enterprise and to diagnose the weaknesses or ills of the enterprise. In other words, performance audit makes an appraisal of how efficiently different activities of the business have been performed. It also prescribed the remedies for any shortcomings or inefficiencies found in the course of audit.

Performance audit is based on the economic principle of efficient utilisation of resources. Thus it evaluates the performance of the business in relation to the expected optimum return. Its aim is to locate and eliminate all inefficiencies in different levels of the organisation to optimise the performance and associated returns. (For detail discussion on Performance Audit please refer to Chapter 11).

### H. Secretarial Audit

This form of audit is of a recent origin. With growing complexities in the corporate legislation due to modification of existing regulations and introduction of new regulations every now and then, corporate actions are highly susceptible to the risk of non-compliance. Since non-compliances, at times, may lead to heavy penalty and even imprisonment, a system of appraisal is of immense value to the organisation. Secretarial audit is the system that evaluates the compliance with various regulations and suggests the management regarding the appropriate course of action in the event of any non-compliance.

In India, the Companies Act, 2013 has made secretarial audit mandatory for all listed companies and also a class of non-listed companies under Section 204 of the Act. (For detail discussion on Secretarial Audit please refer to Chapter 7).

### I. Human Resource Audit

In today's organisations human resource is considered to be one of the most valuable resources. The same is more true in service rendering organisations where human resources directly cause the revenue generation. Unfortunately the conventional financial accounting system largely fails to recognise this resource as accounting and valuation principles are not adequate to capture the peculiarity of human resource. Therefore organisations often discloses important information relating to this resource voluntarily either as a part of financial statements or by incorporating an independent system of accounting and reporting as a supplementary attachment.

Human resource audit refers to an independent appraisal of all such information disclosed by the organisation in its formal reports in order to ensure their authenticity and reliability.

### J. Stock Audit

Stock audit refers to a system of physical verification and valuation of stock or inventory. In case of stock audit the auditor appraises the quantity of inventory, quality or specification of inventory, its composition and proper and accurate valuation.

Stock audit is considered to be an important part of the overall conduct of financial audit of any periodicity. However, in organisations like banks and other financial institutions this is conduced even separately. This is because there is a high possibility of manipulation of inventory kept as a pledge in this organisation. So an independent examination of hypothecated stock is of immense value to them.

### K. Energy Audit

Organisations and more specifically the manufacturing sector consume energy in conducting the production activities. Since most of the energy sources and the non-renewable natural resources like hydrocarbon and fossil fuel, their steady depletion is a real cause of concern. Thus proper utilisation and conservation of these resources is utmost essential. In this context energy audit is really useful.

Energy audit refers to a process that examines whether the operations of the entity are using the right amount of energy or whether there is any wastage or loss due to avoidable reasons and recommends the suitable course of action to eliminate such loss and conserve the energy, in case such mis-utilisations.

### L. Corporate Governance Audit

Audit of corporate governance is a very recent idea. Corporate governance refers to the governance of a company form of organisation. According to N. R. Narayana Murthy, Chairman, Committee on Corporate Governance, SEBI (2003), 'Corporate governance is the acceptance by the management of the inalienable rights of the shareholders as the true owner of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company'.

In today's business environment corporate governance is a very relevant exercise to ensure business ethics and integrity. Considering this most of the countries of the world have implemented a corporate governance code. India is also not an exception to this. Initially through Clause 49 of the Stock exchange Listing Obligations and presently through SEBI (Listing Obligations and Other Requirements) 2015 and Companies Act, 2013, corporate governance codes/rules have been implemented in India.

Corporate governance audit refers to the form of audit that appraises the corporate governance practice of a company with reference to the requirements as laid down in different codes or regulations. The report forms an important part of the annual report.

In India, though a formal corporate governance audit report is not required by law, the company auditor needs to issue a certificate as regards to the compliance of corporate governance related provisions.

### M. Cash Flow Audit

The term 'cash flow' encompasses both cash inflow and cash outflow. In an organisation the smooth conduct of all activities largely depends on this cash flow. This is because, though performance of the organisation is measured in terms of profit, it is highly biased to the accounting policy actually adopted. Moreover, possibility of bad debt also questions the validity of using profit as a performance measurement tool. Thus today, organisations often prepare cash flow statements to analyse the movement of cash during the year and assesses its real performance in terms of net cash flow from operating activities. In addition, analysis of financing and investing activities is also helpful in decision making.

Cash flow audit refers to the technique that appraises each and every item of the cash flow statement based on supporting and subsidiary vouchers. Cash flow audit ensures authenticity and reliability of the cash flow statement of the firm. The aim of this audit is to assist the management in projecting the future cash flow of the firm and to locate areas of inefficiency in form of more than expected cash balance being kept idle.

### N. Compliance Audit

Compliance audit is basically similar to secretarial audit. However its scope is not limited to Companies Act, 2013. Basically, the term 'compliance audit' is used in a general sense to mean an audit technique that examines whether an organisation has complied with all the statutory requirements that it is subject to and recommends the management an appropriate remedy in case there is any non-compliance. Such compliances may be with respect to Companies Act or any other Act, Company Rules, various notices and circulars, accounting, cost and tax computation standards or any other promulgations.

## SUMMARY

- Auditing is a systematic and independent examination of data, statements, records, operations and performance (financial and otherwise) of an enterprise for a stated purpose. Auditing is the critical or controlling aspect of accounting.
- The scope of an audit depends to a large extent on the purpose of the audit. It also depends on the books of accounts maintained by the organisation.
- The objectives are: (1) Primary Objectives, (2) Secondary Objectives and (3) Social Objectives.
  - The primary objective of an audit is to substantiate the accuracy and judge the reliability of the financial statements of a particular accounting period of the organisation and to express an opinion about the truthfulness and fairness of the financial statements.
  - The secondary objectives of audit are detection of errors, detection of fraud, prevention of errors, and prevention of fraud.
  - Audit has certain social objectives which are protection to shareholders, stopping tax evasion, stopping capital erosion, ensuring fair return to investors, reasonable price for consumers, fair wages for labourers etc.
- Basic principles governing an audit are integrity, objectivity and independence, confidentiality, professional care, skill & competence, documentation, planning, audit evidence, accounting system & internal control, audit conclusions & audit report etc.
- Errors are of two types: (1) Clerical Errors and (2) Errors of Principle.
  - Clerical errors can be classified into the following errors of commission, errors of omission, errors of duplication, and compensating errors.

  - Errors of principle take place when, at the time of recording a transaction, the fundamental principles of accounting are not properly followed.
- The term 'fraud' refers to an intentional act by one or more individuals among management, employees or third parties, involving deception for the purpose of obtaining an unjust or illegal advantage.
- Fraud may be of two types: (1) Misappropriation and (2) Manipulation or Falsification of Accounts.
  - Misappropriation may again be of two types: (a) Misappropriation of Cash and (b) Misappropriation of Goods.
- The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved.
- Teeming and Lading is a system of fraudulent manipulation of accounts. It is a method of misappropriation of cash by which the past defalcations are covered up by the current receipts.
- Internal audit is that audit which helps an organisation achieves its objectives by bringing an orderly, disciplined approach to appraise and improve the effectiveness of risk management, internal control, and governance processes.
- An independent financial audit is an independent, objective, and systematic evaluation of an organisation's financial statements by professionally qualified outsiders for the purpose of expressing opinion as to the accuracy, reliability and fairness of the financial statements so that the parties associated with the organisation like debtors, creditors, investors, government, regulators, directors, and managers get information about the financial position of the organisation.
- Periodical audit is that audit which is taken up at the close of the financial year when financial statements have been prepared.
- Continuous audit is an audit where the audit of accounts takes place throughout the year at regular intervals.
- Interim audit is an audit which is conducted in between the two periodical or balance sheet audits with a view to finding out interim profits in order to enable the company to declare an interim dividend.
- The scope of limited review is narrower than the scope of an audit. In limited review procedures, generally accepted auditing standards are not always strictly adhered to.
- Balance sheet audit is an appraisal of the correctness of information found in the balance sheet of an organisation.
- 'Standard audit' signifies detailed examination of certain material or significant items and application of test checks on the remaining items on the basis of auditing standards provided there exists an adequate internal check system.

- A system audit is that audit which examines the adequacy and effectiveness of the prevailing accounting system of the organisation which enables the authority to take appropriate measures for designing a proper accounting system if the existing system of accounts is found to be ineffective.
- EDP audit is an analysis of an organisation's computer and information systems in order to evaluate the reliability of its production systems as well as likely security cracks.
- Complete audit implies meticulous examination and verification of an organisation's financial and accounting records, and internal controls that are deemed to be all-inclusive or relatively comprehensive depending on the size of the company being audited.
- An audit which is conducted considering the particular area of accounting which the owner thinks essential is known as a partial audit. An audit which is undertaken under any specific statute or Act is called 'statutory audit'.
- A non-statutory audit is such an audit which is not required by either the law or a regulatory authority.

## EXERCISE

### A. Short Answer Type Questions (2–4 marks)

1. What are the objectives of audit?
2. What is the primary objective of audit?
3. State the secondary objectives of audit.
4. What is error?
5. What is compensating error?
6. What is error of principle?
7. What are the different types of error?
8. What are the different types of fraud?
9. What do you mean by internal audit?
10. What is independent financial audit?
11. What do you mean by periodical audit?
12. What is continuous audit?
13. Define interim audit. [*C.U. B.Com(H), 2013, 2015*]
14. What is balance sheet audit?
15. What do you mean by standard audit?
16. What is system audit?
17. What do you mean by EDP audit?
18. What is complete audit? [*C.U. B.Com(H), 2013*]
19. What is partial audit? [*C.U. B.Com(H), 2013*]
20. What do you mean by statutory audit?

21. What do you mean by non-statutory audit?
22. Write short note on "Limited review". [*C.U. B.Com(H), 2013*]

**B. Medium Answer Type Questions** **(4–6 marks)**

1. What do you mean by audit? [*C.U. B.Com(H), 2011, 2016*]
2. State the objectives of audit. [*C.U. B.Com(H), 2011*]
3. Discuss different types of errored frauds. [*C.U. B.Com(H), 2014*]
4. Distinguish between error and fraud. [*C.U. B.Com(H), 2016*]
5. Explain the nature of audit.
6. Discuss the scope of audit.
7. State the advantages of audit. [*C.U. B.Com(H), 2014*]
8. Mention the limitations of audit. [*C.U. B.Com(H), 2014*]
9. Distinguish between accounting and auditing.
10. State the relation between audit and law.
11. Explain the relation between audit and statistics.
12. How is audit related to information technology? [*C.U. B.Com(H), 2015*]
13. State the relation between audit and economics.
14. Is audit a social science?
15. Discuss auditor's duty regarding errors and frauds. [*C.U. B.Com(H), 2010, 2012, 2013*]
16. What are the social objects of audit?
17. State the objectives of internal audit.
18. Discuss the advantages of internal audit.
19. Mention the advantages of periodical audit.
20. Explain the advantages of continuous audit. [*C.U. B.Com(H), 2015*]
21. Distinguish between periodical audit and continuous audit.
22. What are the objectives of interim audit?
23. Discuss the advantages of interim audit. [*C.U. B.Com(H), 2013, 2015*]
24. What are the purposes of conducting balance sheet audit?
25. Explain the advantages and disadvantages of partial audit.
26. State the differences between internal audit and statutory audit. [*C.U. B.Com(H), 2014*]
27. Distinguish between statutory audit and non-statutory audit.
28. What do you mean by errors and frauds? [*C.U. B.Com(H), 2014*]
29. Discuss the disadvantages of continuous audit. [*C.U. B.Com(H), 2015*]
30. Discuss the disadvantages of interim audit. [*C.U. B.Com(H), 2013, 2015*]

## C. Essay Type Questions (8–10 marks)

1. Discuss the nature and scope of audit.
2. Explain the advantages of audit.
3. What are the basic principles governing an audit?

   or

   Discuss the principles of auditing. [*C.U. B.Com(H), 2010, 2011*]
4. What are the different types of error and fraud?
5. Explain the advantages and limitations of continuous audit.
6. Explain the advantages and drawbacks of periodical audit.
7. Discuss the advantages and limitations of internal audit.
8. State the advantages and drawbacks of interim audit.
9. Distinguish between periodical audit and continuous audit.
   [*C.U. B.Com(H), 2016*]
10. State the differences between internal audit and statutory audit.
11. Distinguish between statutory audit and non-statutory audit.
12. Explain the concept of 'limited review'.
13. 'Fraud does not always mean misappropriation of cash of goods' – Comment.
    [*C.U. B.Com(H), 2006, 2008, 2011, 2015*]

# 2 CHAPTER AUDIT PROCEDURES AND TECHNIQUES

## CHAPTER OUTLINE

**2.1** Auditing Engagement
**2.2** Audit Planning
**2.3** Audit Programme
**2.4** Audit Note Book
**2.5** Audit Memorandum
**2.6** Audit File
**2.7** Audit Working Paper
**2.8** Audit Evidence
**2.9** Preparation before Commencement of a New Audit

## 2.1 AUDITING ENGAGEMENT

### 2.1.1 Concept and Definition

In case of statutory audit of joint stock companies, trusts and co-operative societies, etc., the appointment of the auditor and his duties and responsibilities are governed by the respective statutes. In all other organisations, however, these are decided by the agreement between the auditor and the client. Such an agreement plays a significant role in the conduct of audit of the client in the sense that if the auditor is held responsible for anything beyond the nature and scope of the current engagement, he can be relieved without any doubt. Additionally, existence of an agreement can easily avoid any misunderstanding or ambiguity cropping up in future. Thus, it is desirable that before commencement of audit, the auditor and the client must agree on the terms of engagement and the auditor should send an audit engagement letter in the interest of both of them.

As per SA-210, 'Agreeing the Terms of Audit Engagements', an auditor and the client should agree to the terms of audit engagement prior to commencement of the audit. The agreed terms should then be recorded by the auditor in an audit engagement letter or any other suitable form of written agreement. However, if the law or regulation prescribes in sufficient detail the terms of audit engagement, the auditor need not record them in written agreement.

### 2.1.2 Contents of Audit Engagement Letter

As per SA-210, 'Agreeing the Terms of Audit Engagements', the audit engagement letter should contain the following:

(i) The objective and scope of audit of financial statements.
(ii) The responsibilities of the auditor.
(iii) The responsibilities of the management with regard to:
   (a) selection of accounting policies
   (b) consistent application of the accounting policies selected
   (c) preparation of financial statements on a going concern basis
   (d) maintenance of adequate accounting records and internal control
   (e) arrangement ensuring the involvement of internal auditor and other personnel
   (f) written representation by the management
(iv) Unrestricted access to all records, documentation and other information required in audit.
(v) Possibility of frauds remaining undetected because of test nature of audit.
(vi) The fact that audit process may be subject to a peer review under Chartered Accountants Act, 1949.
(vii) Identification of the applicable financial reporting framework for the preparation of the financial statements.
(viii) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances where a report may differ from its expected form and content.

### 2.1.3 Acceptance of a Change in the Terms of Audit Engagement

In case of audit of the same organisation, the auditor must consider whether circumstances require any change in the terms of engagement. In case the terms are changed, both the auditor and the client must agree on the new terms. However, the auditor should satisfy himself that such a change is reasonable or justified.

As per SA-210, in case of any revision of the terms of engagement, the following are relevant.

(i) The auditor shall not accept any change where there is no reasonable justification for doing so.
(ii) If, prior to the completion of the audit engagement, the auditor is requested to change the engagement in such a way that conveys lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so.
(iii) If the terms are changed, the auditor and the management shall agree on the new terms and record the same in an engagement letter or other suitable form of written agreement.
(iv) If the auditor is unable to agree to a change and is not permitted by the management to continue the original engagement, the auditor shall:

(a) Withdraw from the audit engagement where possible under the applicable law or regulation, or
(b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

## 2.2 AUDIT PLANNING

### 2.2.1 Concept and Definition

Before the commencement of an audit of the client's business every auditor must prepare a well organised audit plan. Such a planning is indispensible for the efficient and timely completion of the audit work. Audit planning will be required not only for the first time engagement but also for all subsequent engagements in the same organisation. In that way it is a continuous process that begins shortly after the completion of previous audit and beginning of the current engagement. Audit Planning has twofold objectives:

(i) To ensure efficient conduct of audit work in a cost effective manner; and
(ii) To ensure maintenance of highest standards and thereby reduce the risk of any lapses.

### 2.2.2 Activities to be Included in Audit Planning

According to SA-300, 'Planning an Audit of Financial Statements', a planning exercise should include, among all other things, the following activities:

(i) To acquire sufficient information regarding the accounting system followed by the client and associated policies adopted by it.
(ii) To acquire information of the existing internal control system of the organisation in order to decide the degree of reliance to be placed on it.
(iii) Determining the nature, scope and timing of various audit procedures to be followed.
(iv) The analytical procedures to be applied as risk assessment procedure.
(v) To obtain a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with it.
(vi) To determine the materiality.
(vii) To determine the resources to be deployed in specific audit areas such as use of experienced team members for high risk areas or to involve experts on complex matters.
(viii) To determine the amount of resources to be allocated to specific audit areas such as the number of team members to be assigned to observe inventory count at material locations.
(ix) To decide the timing of deploying resources such as whether at interim stage or at key cut-off dates.
(x) To decide how the resources are to be managed, directed and supervised.

### 2.2.3 Advantages of Audit Planning

As per SA-300, 'Planning an Audit of Financial Statements', adequate planning benefits in several ways, such as:

(i) It helps the auditor to devote more attention to important areas of audit.
(ii) It assists the auditor to identify the potential problems and resolve them on a timely basis.
(iii) It helps the auditor to properly organise and manage the audit engagement so that it is performed in an effective and efficient manner.
(iv) It assists in the selection of engagement team members with adequate capabilities and delegation of work to them.
(v) It facilitates the direction and supervision of engagement team members and helps in reviewing their work.
(vi) It assists, where applicable, in coordination of work done by the auditors of subsidiaries and other experts.

### 2.2.4 Considerations in Establishing an Overall Audit Strategy

As per SA-300, 'Planning an Audit of Financial Statements', an auditor needs to consider quite a few number of factors/matters while establishing an overall audit strategy. These are given below. However, the list is not exhaustive but indicative only.

#### A. Characteristics of the Engagement

(i) The financial reporting framework on which the financial information to be audited has been prepared.
(ii) Industry specific reporting requirement such as reports mandated by industry regulations.
(iii) Nature of the control relationship between parent and its components and extent to which the subsidiaries are audited by other auditors.
(iv) The nature of business segment to be audited and the need for any specialised knowledge.
(v) Need for statutory audit of standalone financial statements.
(vi) Availability of work of internal auditor and potential reliance thereon, etc.

#### B. Reporting Objectives, Timing of Audit and Nature of Communications

(i) Entity's timetable for reporting, such as interim or final.
(ii) The discussion with management and those charged with governance regarding the expected time and type of reports and other communications, both written and oral, including the expected communication of the status of audit work.
(iii) Communications with the auditors of components on the matters mentioned above.
(iv) Expected nature and timing of communications among engagement team members.
(v) Other expected communications with third parties.

**C. Preliminary Engagement Activities and Knowledge Gained on Other Engagements**

(i) The determination of materiality in accordance with SA320.
(ii) Preliminary identification of areas with high risk of material misstatements.
(iii) Impact of the assessed risk of material misstatement at the overall financial statement level.
(iv) Results of previous audits that involved with evaluating the operating effectiveness of internal control.
(v) Expected use of audit evidence obtained in previous audits, etc.

## 2.3 AUDIT PROGRAMME

### 2.3.1 Concept and Definition

Before commencing the actual audit work, every auditor generally prepares a detail programme of work. This is popularly known as Audit Programme.

According to W.B. Meigs, an audit programme is a detailed plan of auditing work to be performed, specifying the procedure to be followed in verification of each item in the financial statements and giving the estimated time required.

Thus, audit programme may be defined as a carefully drawn detailed plan of audit work clearly specifying the responsibilities of the audit staff and time allotted to perform the same after incorporating precautionary arrangements against potential errors, frauds and omissions, in order to perform the functions of auditing in an efficient and effective manner.

### 2.3.2 Steps in Preparing Audit Programme

The general steps in preparing an audit programme are to:

(i) decide the extent of examination to be done.
(ii) allocate the duties among the audit staff considering their qualification and experience.
(iii) specify the time for completion of the allotted responsibilities.
(iv) decide the audit techniques to be followed by them.

### 2.3.3 Objectives of Audit Programme

The objectives of audit programme are to:

(i) allocate the audit work among the staff on the basis of their qualification and experience.
(ii) ensure that no important matter is left out.
(iii) arrange the functions to be performed in order of their importance.
(iv) ensure that the audit work is completed within time.
(v) keep written evidence of each work to be done and the progress thereof.

### 2.3.4 Essential Features or Qualities of Audit Programme

A well thought-out audit programme must have the following features or qualities:

**(i) Materiality** An audit programme should include all material items.

**(ii) Flexible** An audit programme must be flexible to add, change or cancel any part of it without affecting the overall plan.

**(iii) Pervasiveness** An audit programme must be so designed as to include all functions however small they can be.

**(iv) Objective Oriented** An audit programme must consider all the audit objectives.

**(v) Logical** An audit programme should be prepared with functions logically selected and arranged.

### 2.3.5 Important Considerations before Preparing Audit Programme

The effectiveness of an audit programme largely depends on its completeness which again requires consideration of a number of important issues. These are as follows:

**(i) Understanding the Nature and Scope of Audit Work** The auditor should prepare the audit programme after deciding the nature and scope of audit work based on legal provisions in case of statutory audit and terms of engagement agreement in case of non-statutory audit.

**(ii) Developing an Idea about the Nature of the Organisation** Since nature of the organisation, commercial or non-commercial, largely determines the scope of audit, the auditor must pay due consideration to this while preparing the audit programme.

**(iii) Management Process** In preparing an audit programme, the auditor should also consider the management process and identify those in charge of governance in order to decide whom to communicate in need of important information so that unnecessary delay in getting the same is avoided.

**(iv) Verification of Important Documents** The auditor needs to verify all the important documents relating to the formation, policy and management of the organisation as they significantly affect the treatment of an item in the accounts. Verifying them beforehand helps the auditor to decide the extent and manner of examination based on which the programmes are generally scheduled.

**(v) Forming an Idea about the Accounting Methods** Since accounting methods and policies adopted differ from organisation to organisation, a prior understanding of the same will help the auditor to clearly specify the scope of the audit work and design the audit programme accordingly.

**(vi) Checking of Last Year's Final Accounts and Auditor's Report** In case of an existing organisation, the auditor should collect and go through last year's final accounts and auditor's report thereon. Such a practice may help the auditor a lot in designing a flawless audit programme for the current year. However, this will not be applicable for a new organisation.

(vii) **Evaluation of Internal Control and Internal Check System** Since existence of a sound internal check and internal control system minimises the possibility of misstatements and frauds, an understanding of the same can largely help the auditor to design an effective work schedule to reduce the time to complete the audit work.

### 2.3.6 Advantages of Audit Programme

A predetermined audit programme offers a number of advantages as follows:

(i) **Detail Plan of Work** Audit programme incorporates every single matter howsoever insignificant. As a result, nothing remains unchecked and thus, audit risk reduces significantly.

(ii) **Effective Co-ordination of All Aspects of Audit Work** A well planned audit programme ensures proper balance between different aspects of audit work. As a result, audit staff does not end up with spending more time on examining petty items and conducts detail examinations of items of material importance.

(iii) **Balanced Distribution of Work** Audit programme distributes different functions to the audit staff based on their experience and qualifications. This reduces any possibility of grievance on the part of the staff.

(iv) **Assessing Progress of Work** Since an audit programme describes in detail the work to be performed by each staff along with the time allotted, the auditor can very easily determine the progress of work during the audit.

(v) **Better Control Over Work** Since an audit programme provides the details of the work, any deviations can be quickly identified. This enhances auditor's control over the entire audit work.

(vi) **Measurement of Incomplete Work** Through the audit programme, an auditor can determine the incomplete portion of any work at a given point of time. As a result it becomes easier for him to reallocate any work in case the person concerned is absent or has left the job.

(vii) **Timely Completion of Work** Since every single function is allotted a specified time, the entire audit work is also completed within the time limit set for the job.

(viii) **Fixing Responsibility for Each Work Done** The audit programme fixes responsibilities of each person of the audit team. Each staff needs to put his signature against the audit procedure performed by him on a daily basis. As a result, negligence on the part of any staff can be easily detected.

(ix) **Documentary Evidence of Actual Work Done** Since the audit programme systematically records the progress of work done and the means of doing them, the auditor can use the same as a documentary evidence to defend any allegation of professional negligence in the court of law.

(x) **Helps in Preparing Future Audit Programmes** Based on the written audit programme of the previous year, the auditor can very easily prepare the audit programme for the current year by making suitable modifications according to the changing circumstances.

### 2.3.7 Disadvantages of Audit Programme

The disadvantages of a predetermined audit programme are as follows:

(i) **Audit Becomes Mechanical and Rigid** Since audit programme allocates the job among the audit staff clearly specifying their respective responsibilities and duties, they need not to do anything beyond the programme. This makes the work mechanical and the staff loses their interest. As a result effectiveness of audit may get reduced.

(ii) **Unrealistic Many a Times** Many a times audit programme places unrealistic targets as regards to the completion of a given job. As a result the staff need to hurry and quality of audit is compromised.

(iii) **Loss of Initiative** Following a fixed audit programme, the efficient audit staff often get dull and lose initiative. This significantly affects their moral.

(iv) **Not Suitable for Small Organisation** Though for a large organisation, audit programmes are quite useful, it is not so for small organisation. For them it only increases the burden of the auditor.

### 2.3.8 Means to Remove the Shortcomings of a Fixed Audit Programme

Though the audit programme offers substantial benefits, using a fixed programme may also create problems at times which can significantly deter the quality of the audit work. In this respect the following steps may be taken to remove the shortcomings of a fixed audit programme.

(i) **Educating the Audit Staff** The audit staff should be clearly informed about the purpose of the audit programme. They should be told that they may go beyond the programme, if the situation so demands. If possible, their opinion should also be considered while preparing the audit programme.

(ii) **Initiating Changes Based on Circumstances** Instead of following the same programme year after year, the auditor may initiate appropriate changes based on circumstances. This will remove monotony of the audit staff engaged in the audit work.

(iii) **Rotation of the Audit Staff** Instead of allocating the same job to the same person repetitively, the auditor may rotate the duty of the staff. This will increase their drive and initiative.

(iv) **Review of the work of the Audit Staff** The performance of the audit staff should be regularly reviewed through surprise check. This will keep them ever alert and more dedicated to their duty.

### 2.3.9 A Sample Audit Programme

The following is a sample audit programme of Intangible Assets:

**Table 2.1:** Audit Programme – Intangible Assets

**Client:**
**Financial Year:**
**Prepared by:** **Date:**
**Reviewed by:** **Date:**
**Approved by:** **Date:**
**Updated by:** **Date:**

| S.No. | Procedure | Extent of Check | Basis of Selection of Sample | Done by | W/P Ref. | M/F Ref. |
|---|---|---|---|---|---|---|
| | **Objectives regarding intangible assets are to establish that:** | | | | | |
| 1. | Amount stated have been correctly calculated on the basis of the accounting policy, which has been consistently applied. | | | | | |
| 2. | Amortisation period and rate is correctly calculated in accordance with generally accepted methods. | | | | | |
| 3. | All intangible assets are recorded in the financial statements. | | | | | |
| 4. | Disposals are accounted for correctly. | | | | | |
| 5. | Assets affected by a permanent diminution in value have been written down to an appropriate value. | | | | | |
| 6. | Expenses relating to intangible assets are valid. | | | | | |
| 7. | Intangible assets and related expenses are properly classified, described and disclosed in financial statements. | | | | | |
| 8. | The amounts reported in the financial statements are in agreement with the accounting records. | | | | | |
| 9. | Amount of research and development expenditure recognised as an expense during the period has been appropriately disclosed in the financial statements. | | | | | |
| 10. | Examine whether the provision of AS-26 has been applied on the intangible assets. | | | | | |
| 11. | Whether intangible assets are in the nature of rights, license, patents, trademarks, goodwill, etc. Whether the basis of amortisation is reasonable and is written off over the primary period of life of such assets. | | | | | |

## 2.4 AUDIT NOTE BOOK

### 2.4.1 Concept and Definition

In the course of conducting audit of an organisation, the audit staff may come across various misstatements, frauds or any other issues which need further clarification from the management or investigation and in-depth observation later on. In order to avoid any chance of such issues being unanswered, the audit staff generally records the same in a separate note book and raises the issue in future. Such a record is known as Audit Note Book.

In this context, it is worthy to mention the difference between audit memorandum and audit note book. Whereas audit memorandum is a statement containing all the relevant information regarding the client's business, audit note book is the note book containing all the problem areas encountered during the course of audit that require consideration, investigation or further observation at a later period.

Generally separate note books are prepared for each client.

### 2.4.2 Contents of Audit Note Book

Generally the following issues are recorded in an audit note book:

(i) Extracts of various important legal documents of client's business such as Memorandum of Association, Article of Association, minutes of the board and shareholders' meetings, terms and conditions of important contracts, relevant details of the partnership agreement in case of a partnership business, etc.
(ii) Any technical or other feature which is of material importance.
(iii) Meaning of all technical terms used in the business (in case they are not common).
(iv) Nature and types of the product and the production process.
(v) Name of all important documents as well as information regarding their source.
(vi) Details of missing vouchers (like description, serial number and name of the relevant books of accounts) whose duplicates must be obtained.
(vii) Description of all errors and frauds discovered during the course of audit.
(viii) Description of all items that need to be investigated further.
(ix) Description of all items that have been investigated, but no explanation has been obtained.
(x) Details of all important letters.
(xi) Casting of all important accounts.
(xii) Important accounting policies followed by the client such as methods of valuation of closing stock, policy of making provisions, etc.
(xiii) Any qualification given by the audit staff regarding any item of material importance.
(xiv) Extracts of various important correspondence with bankers, creditors and debtors.

(xv) Description of items to be included in the audit report.

(xvi) Any inconsistency found in accounting methods.

(xvii) Progress report of the audit.

### 2.4.3 Importance of Audit Note Book

Audit note book is considered to be a valuable input in performing the functions of audit. Because of its immense benefits, it is used by every auditor. The importance is felt on the following grounds:

(i) **Storing all Important Information in One Place** Audit note book stores all important information about the organisation prior and during the course of audit in a single place. As a result, the auditor can access them as and when required. This significantly improves the effectiveness and reduces the time.

(ii) **Documentary Evidence** The audit note book can act as an important documentary evidence as to the steps taken and necessary skill, judgment and care exercised by the auditor. This can be produced before the court while defending any charge of professional negligence on the part of the auditor. In London and General Bank (1895) case law, such a role of audit note book was recognised by the honourable judge.

(iii) **Evaluation of the Audit Staff** By evaluating the sufficiency and relevance of notes contained in the audit note book, an auditor can easily judge the efficiency and knowledge of the audit staff.

(iv) **Help to Settle all Audit Queries** Audit note book compiles all the queries that need explanation from the management or accounting staff. The queries are then placed before the concerned parties at a time. Hence, it minimises the chance of anything being left out, while at the same time ensures that the normal work flow is not hampered due to audit.

(v) **Help in Preparation of Audit Report** Since audit note book contains all the important findings of the audit work including the inadequacies or queries remained unresolved, it assists the auditor a lot in finalising the audit report.

(vi) **Help in Future Audit** The audit note book of any period contains various useful information about the organisation and its system of accounting. Based on such information, the auditor can easily determine the areas which should deserve special attention while performing audit next year.

### 2.4.4 Specimen of Audit Notes from Audit Note Book

A specimen of audit notes from the audit note book maintained by the auditor is given below.

**Table 2.2:** Audit Note Book (excerpt)

| Voucher No. | Account Affected | Amount (₹) | Query Raised | How Disposed of |
|---|---|---|---|---|
| 11 | Machinery | 3000 | Amount wrongly capitalised | Rectified after consulting Mr. X, the Chief Accountant |
| 46 | Provident Fund | 2850 | Late deposition of subscription | Clarified with Mr. Y from HR |
| 87 | Advertisement | 7000 | Not sanctioned by MD | Sanction obtained |
| 142 | M/S PQR & Co. | 34000 | No TDS | TDS deducted and deposited |
| 179 | Rent | 4000 | Receipt not available | Receipt obtained |

## 2.5 AUDIT MEMORANDUM

### 2.5.1 Concept and Definition

Before the commencement of audit work, every auditor must obtain detail understanding about the structure of the organisation and its operating policies. This information can help the auditor a lot in determining the scope and process of auditing. Audit memorandum may be defined as the statement that contains all the above information in an organised manner.

### 2.5.2 Content of Audit Memorandum

According to E.L. Kohlar, an audit memorandum should contain the following information:

(i) The organisation structure and its ownership, and any recent changes in this regard.
(ii) A brief history of changes in its net assets.
(iii) Details of major products and markets.
(iv) Pricing policy and trends in sales.
(v) Location of plants and offices.
(vi) Raw material sources and their price trend.
(vii) Names of responsible officers, their interrelationship, chain of command and controlling power.
(viii) Books of accounts maintained.
(ix) Changes in production planning, cost of the product and management structure.
(x) A brief description of subsidiaries and how they are controlled by the parent.
(xi) Investment policy and policy regarding reserves and provisions.
(xii) Information regarding internal control, accounting policies, costing methods and internal audit.

## 2.6 AUDIT FILE

### 2.6.1 Concept and Definition

The file which is used by the auditor to preserve all the important documents relevant for the audit of an organisation is known as audit file. It basically acts as the archive of all the important statements, notes, etc. generated during the conduct of audit of the organisation.

According to SA-230, 'Audit Documentation', audit files are defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise of audit documentation for a specific engagement.

In auditing, this audit file has immense importance. Generally the same auditor is engaged by an organisation year after year. In such a case, is the current year's audit related papers may require to be consulted in the next year also. The audit file can be used as a reference in this case. In addition to this, the audit file can also be used to defend any charge of professional negligence brought against the auditor by the client or any third party.

### 2.6.2 Classification of Audit Files

Audit files are generally of two types—Permanent Audit File and Temporary Audit File.

#### A. Permanent Audit File

Permanent audit file contains all the documents which are of continuing importance for the audit of succeeding years. The audit papers that are preserved in a permanent audit file include:

(i) Name, address and contact information of the client.

(ii) Documents describing the legal and organisational structure of the client's business. These include memorandum of association and article of association in case of a company, partnership deed in case of a firm, etc.

(iii) Extracts or certified copies of important legal documents, long-term agreements with third parties, etc.

(iv) Copies of various important instructions issued by the management.

(v) Certified copies of the resolutions of shareholders' meetings and board meetings that are of continuing importance.

(vi) Certified copies of audited accounts of the previous year.

(vii) Statements regarding the accounting procedures and internal control system. For example, internal control check list, flow chart, list of different books of accounts, important forms, etc.

(viii) Analysis of significant ratios and trends.

(ix) Record of communication with previous auditor.

(x) Significant audit observations of earlier years.

### B. Temporary Audit File

Temporary audit file contains documents relevant for the audit of the current year only. The audit papers that are kept in a temporary audit file include:

(i) Documents describing important changes incorporated in the audit programme considering the changes in the internal control system, accounting policies and procedures.
(ii) Current year's audit memorandum, audit plan and audit programme.
(iii) Audit evidences procured during the course of current audit.
(iv) Internal control questionnaire and flow charts and notes on the system of internal control.
(v) Various analytical statements prepared during the course of current audit. For example, aging schedule of customers, comparative statements, etc.
(vi) Different accounting schedules such as schedule of debtors and creditors, schedule of contingent liabilities.
(vii) Copies of the communication with previous auditor, experts and others.
(viii) Certified copies of the resolutions of shareholders' meeting and board meetings held during the year.
(ix) Copies of queries raised during the audit and answers obtained.
(x) Copies of communication with the client regarding weakness in internal control system, wrong accounting policies followed, rectifications suggested, etc.
(xi) Letter of representation or confirmation received from the client.
(xii) Auditor's conclusion relating to significant matters.
(xiii) Copies of various budgets, financial statements and relevant audit report.

## 2.7 AUDIT WORKING PAPER

### 2.7.1 Concept and Definition

In course of audit of an organisation, an auditor adopts various methods and procedures to accumulate and thereafter analyse audit evidences and other important documents to reach at some meaningful conclusion regarding his engagement. Audit working papers include all such records kept by an auditor in relation to the evidences accumulated, methods and procedures adopted and conclusions reached during the course of the audit.

According to W.B. Meigs, audit working papers include all such documents kept by the auditor that are useful to substantiate various tasks performed, methods and procedures adopted and conclusions reached in the conduct of an audit.

As per SA-230, 'Audit Documentation', audit working papers (also called audit documentation) refer to the record of audit procedures performed, relevant audit evidences obtained and conclusions the auditor reached.

Such records can be kept either in physical form or in an electronic form.

### 2.7.2 Purpose of Audit Working Papers

According to SA-230, 'Audit Documentation', audit working papers or audit documentation serves a number of purposes as follows:

(i) Providing evidence of auditor's basis for a conclusion about the achievement of the overall objectives of the auditor.
(ii) Providing evidence that audit was planned and performed in accordance with Standards of Audit (SAs) and applicable legal and regulatory requirements.
(iii) Assisting the engagement team to plan and perform the audit.
(iv) Assisting members of the engagement team responsible for the supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA220, 'Quality Control for an Audit of Financial Statements'.
(v) Enabling the engagement team to be accountable for its work.
(vi) Retaining a record of matters of continuing significance to future audits.
(vii) Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
(viii) Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

### 2.7.3 Contents of Audit Working Papers; Some Guidelines

As per SA-230, 'Audit Documentation', an auditor should follow the guidelines mentioned below to decide on the form, content and extent of audit documentation (or working papers).

(i) The auditor shall prepare audit working papers on a timely basis. They should be prepared while performing the task itself rather than after the audit work is performed.
(ii) The auditor shall prepare audit working papers that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:
    (a) the nature, timing and extent of audit procedures performed to comply with the SAs and applicable legal and regulatory requirements;
    (b) the results of the audit procedures performed and the audit evidence obtained; and
    (c) significant matters arising during the audit, the conclusion reached thereon and significant professional judgments made in reaching those conclusions.
(iii) In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
    (a) the identifying characteristics of the specific items or matters tested;
    (b) who performed the audit work and the date such work was performed; and
    (c) who reviewed the audit work performed and the date and extent of such review.
(iv) The auditor shall document discussions of significant matters with management, those charged with governance and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

(v) If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.

(vi) If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in a SA, the auditor shall document how the alternative audit procedures performed achieved the aim of that requirement, and the reasons for the departure.

### 2.7.4 Examples of Audit Working Papers/Documentation

As per SA-230, examples of audit working paper/documentation include:

(i) Audit Programmes
(ii) Analyses
(iii) Issues memoranda
(iv) Summaries of significant matters
(v) Letters of confirmation and representation
(vi) Checklists
(vii) Correspondence (including e-mail) concerning significant matters.

The auditor may include abstract or copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation, however, is not a substitute for the entity's accounting records.

The auditor, however, need not include in audit documentation, superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors and duplicates of documents.

### 2.7.5 Preservation of Audit Working Papers

Audit working papers are very important documents. This is because, many of the documents collected or prepared are of continuing significance and can be used in future audit also. Additionally, these documents can be used by the auditor to defend any allegations of professional negligence. Hence, relevant audit working papers must be filed and preserved for a sufficient period of time to meet the needs of the auditor's practice and satisfy any legal requirements in future.

### 2.7.6 Confidentiality of Audit Working Papers

Audit working papers are highly confidential. They contain important information about the organisational structure, management procedures, accounting policies, etc. of the client organisation. This information may be of high value for the competitors and once leaked may be misused also. Thus, whosoever is in possession of the working papers should be responsible for their safe custody. These should never be made available to any third party except with the permission of the client or unless the law demands.

### 2.7.7 Ownership and Custody of Audit Working Papers

While recognising the need for preserving and maintaining the confidentiality of audit working papers, an important and relevant question that arises is who is the owner and custodian of the audit working papers. Significant differences of opinion exist in this respect. One view has been that the audit working papers should be the property of the client. This is because such papers are prepared based on the client's books of accounts and other documents provided by him and contains confidential information about his business. Thus, their ownership must lie with the client as otherwise the confidentiality may be compromised. The other view, however, contends that audit working papers contain information procured and evaluated by the auditor in properly discharging his duties. Therefore, the auditor can easily defend himself against any future allegation of negligence based on the working papers. Hence, it is the auditor who should be the sole owner and custodian of the working papers.

In this respect decisions of a few notable case laws can be mentioned here. In *Leicestershire County Council* vs. *Michael Faraday and Partners Ltd*. (1941), it was held that if the auditor acts as an agent of the client such as to resolve any income tax dispute, etc., he cannot claim any right over the working papers. Similar to this decision, in *Sockockinsy* vs. *Bright Graham and Co.* (1938), it was held that an auditor is an independent evaluator and not an agent of the client and accordingly all working papers prepared by the auditor in the course of the audit should belong to the auditor only. In *Chantrey Martin and Co*. vs. *Martin* (1953), the court recognised the difference between an auditor's role as an independent professional and that as an accountant or expert, being an agent of the client. It was held that when the auditor acts as an independent professional, he himself will be the owner of all working papers.

Currently the above controversy has been resolved by the professional bodies through different regulatory pronouncements. In India, as per SA-230, 'Audit Documentation', audit working papers are the property of auditor and not of the client. On request the auditor can handover the same to the client if he wants. But the client cannot compel him to do so. However, since the working papers contain confidential information about the business of the client, it will be a duty of the auditor to maintain high degree of confidentiality regarding the same and preserve them for a period of time sufficient to meet the needs of his practice and satisfy any future legal requirements.

## 2.8 AUDIT EVIDENCE

### 2.8.1 Concept and Definition

In his final audit report, every auditor needs to express an unbiased opinion whether financial statements submitted to him exhibit true and fair view of the financial performance and financial state of affairs of the client's business. He should, however, do so only after carefully scrutinising all the available evidences substantiating the complete and appropriate recording of the transaction in the books of accounts. These evidences are called audit evidences.

As per SA-500, 'Audit Evidence', the term 'audit evidence' includes information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

In short, substantive evidence collected by an auditor from various sources to base his opinion on the financial statements of the organisation is called audit evidence.

### 2.8.2 Need or Importance of Audit Evidence

Audit evidence is an important element of audit process. In order to form his unbiased opinion on the reliability and fairness of the financial performance and financial state of affairs, an auditor needs to objectively examine the financial statements based on sufficient and appropriate evidence. Opinion based on casual and subjective evaluation may leave material misstatements or frauds undetected and as a result the auditor may be held guilty of professional negligence.

The auditor, therefore, should always try to obtain sufficient and appropriate audit evidence and analyse them thoroughly before arriving at any opinion. Only by doing so, the auditor can keep the audit risk to a substantially low level.

In SA-200, it is recognised that reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Here, sufficiency refers to the quantity and appropriateness refers to the quality of audit evidence.

### 2.8.3 Sources or Types of Audit Evidence

Depending upon the source, audit evidences may be of two types—internal evidences and external evidences. These are discussed below:

#### A. Internal Evidences

These are evidences collected from within the organisation. For example, sales invoices, counterfoils of cash memos, goods received notes, credit notes and debit notes, etc.

#### B. External Evidences

These are evidences collected from outside sources. For example, quotations, confirmation from debtors and creditors, etc.

### 2.8.4 Relevance and Reliability of Audit Evidence

In order to arrive at an appropriate conclusion regarding the truthfulness and fairness of financial statements, the audit evidences under examination must be relevant and reliable.

As per SA-500, relevance of audit evidence deals with the logical connection with the purpose of audit procedure and is therefore affected by the direction of testing. For example, while testing for overstatement in the existence or valuation of accounts payable, examining the recorded accounts payable may be relevant. However, while testing for understatement in the existence or valuation of accounts payable, instead of verifying recorded accounts payable, examining disbursements, unpaid invoices, supplier's statements and unmatched receiving reports may be relevant.

Again, as per SA-500, reliability of audit evidence depends on its source (whether internal or external) and nature (whether visual, documentary or oral). However, the following generalisations may be considered useful while assessing the reliability of audit evidence.

(i) Evidence obtained from independent and external sources are more reliable.
(ii) Internal evidence becomes more reliable when the related internal control over its preparation and maintenance is effective.
(iii) Evidence obtained directly by the auditor is more reliable than those obtained indirectly or by inference.
(iv) Evidence in documentary form is usually more reliable than oral representation.
(v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles or documents that have been filmed or digitised.

In order to be certain about the reliability of audit evidence in relation to a particular matter, an auditor should try to obtain evidence from various sources. This is because evidences obtained from alternative sources and in different forms, if found consistent, substantially increases the reliability. Thus, in case there appears any inconsistency, the auditor must obtain additional evidence by conducting other audit procedures. Even he should submit a disclaimer in case sufficient and reliable audit evidence is not available.

### 2.8.5 Audit Procedures to Obtain Audit Evidence

As per SA-315 and SA-330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(i) Risk assessment procedures; and
(ii) Further audit procedures, which comprise:
   (a) Test of control or Compliance Procedure, and
   (b) Test of details and analytical procedures known as Substantive Procedure.

Risk assessment procedures are the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion level (assertions are management representations, explicit or otherwise, that are embodied in the financial statements).

Risk assessment procedures include the following:

(i) Inquiries of management and others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
(ii) Analytical procedure to identify aspects of the entity which the auditor is unaware or transactions of unusual nature which may indicate potential misstatement.
(iii) Observation and Inspection.

Compliance procedure is the audit procedure designed to evaluate the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level. Compliance procedures include tests of following assertions:

(i) The internal control exists.

(ii) The control system is operating effectively.
(iii) The control has operated throughout the period under audit.

Finally, substantive procedure is the audit procedure designed to detect material misstatements by either test of details, i.e. vouching and verification or by analytical procedures, i.e. analysis of significant ratios and trends.

Substantive procedures provide assurance in respect of the following assertions:

(i) The asset or liability exists on a given date.
(ii) The entity is the rightful owner of the asset and the liability is a valid obligation of the entity.
(iii) There is no unrecorded assets, liabilities and transactions.
(iv) Assets and liabilities have been recorded at appropriate value.
(v) Transactions have taken place during the relevant accounting period.
(vi) Transactions have been recorded at appropriate value.
(vii) Disclosures have been done in accordance with the recognised policies and relevant provisions of law.

### 2.8.6 Methods of Obtaining Audit Evidence

The procedures stated above are a broader classification of the procedures actually used in obtaining the audit evidence. In specific, an auditor needs to apply the following procedures or methods for obtaining sufficient and appropriate audit evidence.

**(i) Inspection** Inspection involves examining records or documents, whether internal or external, in paper form or otherwise or a physical verification of a tangible asset. Inspection can provide reliable audit evidence depending on their nature and source and effectiveness of the internal control over their generation and processing. An example of inspection being used to obtain audit evidence is to physically examine the tangible asset for confirming its existence and inspecting the title deed or purchase invoice for confirming its ownership.

**(ii) Observation** Observation consists of looking at a process or procedure being performed by others on a real time basis. For example, the auditor may observe the inventory counting by the entity's personnel and obtain evidence that it is done correctly.

**(iii) External Confirmation** External confirmation represents audit evidence obtained by the auditor as a direct written response from a third party, in paper form or by electronic or any other medium. For example, confirmation from the customer about the terms of agreement.

**(iv) Recalculation** Recalculation consists of checking the mathematical accuracy of the documents or records. This may be performed manually or electronically.

**(v) Reperformance** Reperformance involves auditor's independent execution of procedures or controls that were originally performed as part of entity's internal control.

(vi) **Analytical Procedures** Analytical procedures involve evaluation of financial information by studying possible relationships among both financial and non-financial data and investigating identified fluctuations from previous years that are inconsistent. This is done by studying significant ratios and trends and inspecting abnormal fluctuation in the amount of an item.

(vii) **Inquiry** Inquiry involves seeking information, both financial and non-financial, from knowledgeable persons within or outside the entity. Inquiries may range from formal written inquiries addressed to external parties to informal inquiries addressed to client's staff.

In this context, it is worthy to mention that the procedures discussed above may be used as risk assessment procedure, compliance procedure or substantive procedure depending on the context in which they are applied by the auditor.

## 2.9 PREPARATION BEFORE COMMENCEMENT OF A NEW AUDIT

In order to conduct the audit effectively and efficiently, every auditor must follow some systemic steps. Though the steps may differ based on the nature of the organisation such as sole proprietorship, partnership or joint stock company, a few general steps can always be suggested. Following are some important steps before commencement of audit of an organisation.

(i) **Collection of Appointment Letter** At the very beginning, the auditor must collect a valid appointment letter from the client. The validity of the appointment letter is to be judged based on the statutory provisions governing the organisation. For example, in case of a company, the auditor must verify whether the appointment letter has been issued in accordance with the provisions laid down in the Article of Association in this respect. In case of a partnership firm, such validity must be tested against the partnership agreement or other prevailing Act. Even the professional pronouncements from the concerned professional body imposing any restriction must also be taken care of.

(ii) **Communication with the Previous Auditor** Before accepting appointment, the auditor must communicate with the previous auditor and enquire why he has not been reappointed. The auditor must investigate whether the previous auditor resigned voluntarily or was removed forcibly and if so, whether such removal was in accordance with a formal decision and procedure and following the provisions of law, if applicable.

(iii) **Acceptance of Appointment** Being satisfied with the validity of appointment, the auditor should formally accept the appointment and inform the client about such acceptance. In case of joint stock company, the statutory auditor must within 30 days of receiving the appointment letter, intimate the Registrar of Companies whether he has accepted the appointment or not. In case of non-statutory organisations, however, such written intimation is not mandatory.

**(iv) Understanding the Nature and Scope of Audit Work** The auditor must form an understanding about the nature of the audit work based on different legal provisions in case of statutory audit and from the terms of engagement in case of non-statutory audit. In case there is any ambiguity, the auditor should clarify the same from the client.

**(v) Understanding the Nature of the Organisation** Before commencing audit, the auditor must collect information about the nature of the organisation, its history, list of products and services, its competitive position, general problems of the industry concerned, etc. He should also study the organisational structure, authority relationships, etc. All these will help him to develop a general understanding of the business of the organisation and its management procedure.

**(vi) Verification of Important Documents** In order to gain sufficient knowledge about the operation of the concern, the auditor will have to study all the important documents regarding its formation and operating policies. Such documents will include the memorandum of association, article of association, prospectus, minutes of meetings, etc. in case of a joint stock company, partnership deed in case of partnership, relevant rules and bye-laws in case of co-operative societies and trust deed in case of trusts.

**(vii) Study of Accounting System** After verifying the documents, the auditor must form an idea about the accounting system of the organisation he is going to audit. This is necessary as different organisations may have different accounting procedures and policies. So, the auditor should collect information about the use of generally accepted accounting principles, method of valuing closing stock, provisioning arrangements, etc. to familiarise himself with the accounting system of the client.

**(viii) Collection of a Complete List of Books of Accounts** The auditor must also collect a complete list of books of accounts of the organisation and the names of all the personnel entrusted to maintain those books. He should collect a list of the names of all the higher level officials and their specimen signatures. The list must be authenticated by proper authority.

**(ix) Checking Last Year's Final Accounts and Auditor's Report** In case of an existing organisation the auditor will have to thoroughly study previous year's final accounts and auditor's report thereon. Previous auditor's comments and recommendations may be of great help for the current auditor in deciding upon his scope of work.

**(x) Requesting for Keeping Necessary Records, Lists, etc. Ready** The auditors should also request the client to finalise the recording, casting and balancing of accounts, and to keep important lists, vouchers, statements, etc. ready for inspection. Otherwise, there will be unnecessary delay in conducting the audit.

**(xi) Study the Soundness of Internal Control System** The auditor must also see whether there exists any internal control system in the organisation and if so, how effective and reliable it is. This evaluation will help him to determine the extent of checking to be followed in the course of audit of various transactions.

**(xii) Review the Work of Internal Auditor** In case the organisation has a separate internal audit department, the auditor should also assess the effectiveness of the same and thereby decide about the reliance to be placed on their reports. A well functioning internal audit department can significantly reduce the burden of a statutory auditor.

**(xiii) Preparation of Audit Programme** After following the above steps, the auditor must finally prepare a well planned and effective audit programme. The audit programme will clearly specify the extent of checking to be done and audit procedures to be used to obtain audit evidence along with a proper allocation of work based on the qualifications of the staff and time-frame to complete such work. The success of the audit will largely depend on the soundness of the audit programme.

As mentioned earlier, these steps are indicative only and actual steps to be followed may vary depending upon the situation. (For detail discussion, follow unit 1 and 3 of module II).

## SUMMARY

- **Auditing Engagement** Before commencement of audit, the auditor and the client must agree on the terms of engagement and the auditor should send an audit engagement letter in the interest of both of them.
- **Audit Planning** Before the commencement of an audit of the client's business every auditor must prepare a well organised audit plan for the efficient and timely completion of the audit work.
- **Audit Programme** It may be defined as a carefully drawn detailed plan of audit work clearly specifying the responsibilities of the audit staff and time allotted to perform the same after incorporating precautionary arrangements against potential errors, frauds and omissions, in order to perform the functions of auditing in an efficient and effective manner.
- **Audit Working Papers** As per SA-230, 'Audit Documentation', audit working papers (also called audit documentation) refer to the record of audit procedures performed, relevant audit evidences obtained and conclusions the auditor reached. Audit working papers are the property of auditor and not of the client.
- **Audit File** According to SA-230, 'Audit Documentation', audit files are defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise of audit documentation for a specific engagement. Audit files are generally of two types – Permanent Audit File and Temporary Audit File.
- **Audit Note Book** In the course of conducting audit of an organisation, the audit staff may come across various misstatements, frauds or any other issues which need further clarification from the management or investigation and in-depth observations later on. The note book containing all the above queries for which explanations will be sought from the management is called audit note book.

- **Audit Memorandum** Audit memorandum may be defined as the statement that contains information such as organisation structure, its operating policies, details of products, pricing policies, etc. in an organised manner.
- **Audit Evidence** Substantive evidence collected by an auditor from various sources to base his opinion on the financial statements of the organisation is called audit evidence.
- **Audit Procedures to Obtain Audit Evidence** Audit evidences are obtained by performing - (i) Risk assessment procedures and (ii) Further audit procedures. The latter comprise of (a) Test of control or Compliance procedure and (b) Test of details and Analytical procedures (known as Substantive Procedure).
- **Methods for Obtaining Audit Evidences** Inspection, Observation, External confirmation, Recalculation, Re-performance, Analytical procedures and Inquiry.
- **Preparation before Commencement of a New Audit** The steps include – collecting appointment, communication with previous auditor, accepting appointment, understanding the audit scope and the organisation, document verification, studying accounting system, collecting list of books of accounts, last year's accounts, testing internal control, review internal auditor's work, preparing audit programme.

## EXERCISE

### A. Short Answer Type Questions (2–4 marks)

1. What is an audit programme? [*C.U. B.Com(H), 2008, 2010*]
2. What is an audit file? [*C.U. B.Com(H), 2011*]
3. What is an audit memorandum? Is it different from an audit programme? [*C.U. B.Com(H), 2014*]
4. Mention any two items kept under permanent audit file. [*C.U. B.Com(H), 2015*]
5. Define audit planning.
6. What is audit working paper?
7. What is audit evidence?

### B. Medium Answer Type Questions (4–6 marks)

1. What are the benefits of an audit programme? [*C.U. B.Com(H), 2008, 2010*]
2. What do you mean by audit working papers? Can an auditor keep the audit working papers with himself? [*C.U. B.Com(H), 2010*]
3. What are the contents of audit file? [*C.U. B.Com(H), 2009, 2011*]
4. Write short notes on:
   (a) Audit Programme [*C.U. B.Com(H), 2012*]
   (b) Audit Note Book [*C.U. B.Com(H), 1992, 2008*]
   (c) Audit Evidence [*C.U. B.Com(H), 2010, 2012*]
   (d) Audit Memorandum [*C.U. B.Com(H), 2013*]

5. What is audit evidence and what are its sources? [*C.U. B.Com(H), 2008*]
6. What is an audit programme? What are its advantages? [*C.U. B.Com(H), 2008, 2010*]
7. What is an audit file? Discuss its contents. [*C.U. B.Com(H), 2011*]
8. Discuss the steps to be performed before commencement of an audit. [*C.U. B.Com(H), 2012*]
9. Mention any six important items included under Audit Engagement Letter. [*C.U. B.Com(H), 2013, 2015*]
10. Discuss the methods of collecting audit evidence. [*C.U. B.Com(H), 2014*]
11. What is audit working paper? Discuss about the ownership and custody of audit working papers mentioning the relevant auditing standard and decisions of case laws. [*C.U. B.Com(H), 2014*]

### C. Essay Type Questions (8–10 marks)

1. Discuss the steps to be performed before commencement of an audit. [*C.U. B.Com(H), 2008, 2010*]
2. What is an audit programme? What are the advantages and disadvantages of conducting audit in accordance with a pre-determined programme? How can the disadvantages be removed?
3. Discuss the various methods of obtaining audit evidence. How will you assess the reliability of the audit evidence?
4. Discuss the procedures applied for obtaining audit evidence.

# 3 CHAPTER INTERNAL CONTROL AND INTERNAL AUDIT

## CHAPTER OUTLINE

**3.1** Introduction
**3.2** Internal Check
**3.3** Internal Check—Preparation of Check-lists
**3.4** Liability of the Statutory Auditor for Relying on Internal Check System
**3.5** Internal Check System for Some Transactions
**3.6** Internal Control
**3.7** Comparison between Internal Control and Internal Check
**3.8** Internal Control in a Computerised Environment
**3.9** Meaning of Internal Control Questionnaire (ICQ) and Preparation of ICQ
**3.10** Internal Audit
**3.11** Differences between Internal Check and Internal Audit
**3.12** Differences between Internal Control and Internal Audit
**3.13** Comparison between Internal Control, Internal Audit and Internal Check
**3.14** Legal Requirement of Internal Audit
**3.15** Relying Upon the Work of Internal Auditor

## 3.1 INTRODUCTION

Formerly, business systems were usually installed with the objectives of getting the work done by the cheapest and quickest methods available. Whilst these objectives have not been lost sight of, it has been realised that the establishment of the piecemeal methods of uncoordinated work process is ultimately neither cheap nor efficient. An overall planning is necessary to establish a flow of work through the whole business, ensuring it to run smoothly and efficiently and with the added requirement that its assets shall be safeguarded at the same time.

This overall plans and its practical operation are included under the title of internal control which is established by the management. Although the auditor, in his role as an auditor, has

no right to practice any practical method of control to be operated, he is virtually concerned with it, as the efficiency or otherwise of the internal control will greatly influence the auditor's method of working.

## 3.2 INTERNAL CHECK

### 3.2.1 Concept and Definition

Internal check is a part of internal control. It is basically a process of arrangement of duties of various staff of a business in such way that work of one is automatically checked by the next staff while performing his duties. As a result any error committed by the previous staff is automatically detected and corrected by the next one and frauds are easily prevented. For example, in case of a transaction involving purchase of materials for production, one staff may collect the material requisition note, another (say the purchase manager) may place the purchase order, the next one (say the storekeeper) may receive the goods, verify the same with the invoice as well as purchase order and record the same in the bin card while another (the accountant) may enter the transaction in the stores ledger and yet another (the cashier) may pay the bill after it gets approved by the finance department. As a result error or fraud committed at any level can be detected by the next staff very quickly and easily.

Spicer and Pegler has defined internal check as *"an arrangement of staff duties where by one person is allowed to carry through and to record every aspect of a transaction so that without collusion between two or more persons, fraud is prevented and at the same time the possibilities of error are reduced to a minimum."*

According to F.R.M.De Paula, *"An internal check means practically a continuous internal audit carried on by staff itself, by means of which the work of each individual is independently checked by other members of the staff."*

According to The Institute of Chartered Accountant of England and Wales, London, *"Internal Check System is a system of instituting checks on the day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors and frauds".*

According to the Special Committee on Terminology, American Institute of Accountants, *"Internal check, a system under which the accounting methods and details of an establishment are so laid out that the accounts and procedures are not under the absolute and independent control of any one person rather on the contrary, the work of one employee is complementary to that of another and that a continuous audit of the business is made by employees."*

Thus internal check may be defined as a system of allocation of duties among the staff of the entity in a way that it eliminates the chances of any duplicity of work and at the same time

ensures that the work of one is interlinked with that of another, so that the work done by the previous employee is automatically checked by the next one.

### 3.2.2 Objectives of Internal Check

Following are the objectives of an internal check system:

(i) **Elimination of Frauds and Errors** The main objective of internal check is to eliminate or at least minimise the frauds and errors that may be committed by the staffs of an organisation.

(ii) **Ensuring Detection of Errors and Frauds at an Early Stage** Internal check attempts to detect errors and frauds promptly which helps to minimise their effects in the long run.

(iii) **Increasing Reliability of Financial Data** Another objective of internal check system is to increase the reliability of financial data of an organisation by ensuring timely recording of all transactions pertaining to the organisation in a particular period.

(iv) **Ensuring Smooth Flow of Work** Division of work done while implementing internal check ensures smooth flow of work.

(v) **Ensuring Careful and Continuous Work by Staff** Internal check exercise moral pressure over the staffs so that they work carefully and continuously to minimise the chances of errors and frauds.

(vi) **Prompt Preparation of Final Accounts** Internal check ensures prompt recording of transactions in an orderly manner. This helps in finalising the accounts promptly.

(vii) **Improving Overall Efficiency** Another important objective of internal check is to improve overall functional efficiency of the organisation.

### 3.2.3 Essential Characteristics of Internal Check System

Certain qualities are needed to make an internal check system more effective and efficient. These are known as the essential characteristics of internal check system. These are as follows:

(i) **Division of Work** Before applying internal check, it is necessary to divide the entire task among the staff in such a way that the work of one staff can be checked automatically by another. For example, when a staff takes the responsibility of purchase, then another staff should make its payment.

(ii) **Provision of Check** The organisation should set up such a provision that a work done by any staff can be checked by another staff. For example, an officer may check the work done by a staff by reallocating the duties.

(iii) **Use of Devices** In this modern world, various devices can be used to perform some functions automatically. For example, the organisation may use time keeping machine to determine the time spent by a worker on a job. Use of machines may help to make internal check easier.

(iv) **Compulsory Leave** Every member of the staff should be encouraged to go on a leave at least once in a year. So that his portion of work done is verified by another.

(v) **Self-balancing System** An organisation may also use self balancing system of maintaining ledger where errors are detected and rectified easily.

(vi) **Job Rotation** An organisation needs to transfer the staff from one job to another so that the work of previous staff can be checked by the later.

(vii) **Specialisation** The organisation must also arrange for specialised training programme to make the staff well equipped with the knowledge to perform a task efficiently.

(viii) **Control over Employees** Generally, chances of frauds are high in case there is direct contact between staff and the consumer or public. So, a manager can keep eyes in those works so that the internal check system can be made more effective.

### 3.2.4 Advantages of Internal Check System

Internal check system is beneficial to both the auditor and the client in a number of ways.

#### (i) Advantages to the Auditor

(a) **Saves Time and Cost** If internal check system is effective, an auditor can apply test check rather than checking the books of accounts in detail. So, he can save his time and labour which simultaneously saves the cost.

(b) **Improved Quality of the Audit Work** When internal check is sound the auditor can devote more time to appraise the critical areas. This improves the quality of the audit work.

#### (ii) Advantages to the Client

(a) **Less chance of Error and Fraud** Rights, responsibilities and duties of each staff are clearly defined under the internal system. So, they perform work whole heartedly which reduces the chances of errors and frauds.

(b) **Smooth Flow of Work** Internal check system is based on the principle of division of labour. Accordingly when the work is distributed among the employees based on their skill the entire work process gets completed within reasonable time and at the minimum cost.

(c) **Moral Pressure on Employees** Work of every staff is checked automatically. So, they remain honest.

(d) **Prompt Finalisation of Accounts** Every book of accounts remains correct and is checked automatically. So accounts can be finalised in less time, and with less cost and labour.

### 3.2.5 Disadvantages of Internal Check System

Though the internal check system is useful in many respect, even then it has some disadvantages as follows:

(i) **Dependence on Other** Under internal check system a staff depends on another staff from whom the work flows. Therefore to ensure timely conduct of the entire work one may have to hurry and thus commit an error.

(ii) **Conflict among Staff Members** Under internal check system, once the work performed by one staff is checked by another staff and any error or fraud is detected, there may arise conflict between the staff members.

(iii) **Planned Frauds** Planned frauds with involvement of a number of staff may not get detected by internal check.

(iv) **Carelessness** Employees may also develop a sense of carelessness in the way that everyone thinks that his mistake will be detected by the net staff.

(v) **Not Suitable for Small Concern** Small organisations cannot use internal check system as it needs engagement of more manpower and accordingly involves high incidence of cost.

(vi) **Audit Risk** In organisations with effective internal check the auditor may be tempted to adopt test checking instead of routine checking. This, at times, sufficiently increases the audit risk.

### 3.2.6 Evaluation of Internal Check by Auditor

The auditor should evaluate the internal check system before relying on it. For this purpose he should consider the following aspects and determine the effectiveness of the existing internal check system.

(i) no single person is allowed to execute a transaction in total. The division of work should be such that the work of one is automatically checked by another.
(ii) duties of every clerk in the organisation have been reshuffled from time to time so that no single staff remains attached with a particular job forever.
(iii) every staff of the organisation have taken annual holiday at their will or have been compelled to do so.
(iv) each and every receipt and despatch of goods is properly recorded.
(v) every transaction takes place under the supervision of competent authority.
(vi) modern machineries for maintaining accounting records have been fully utilised.
(vii) self balancing system is in vogue.
(viii) notice have been sent out to every debtors and creditors to obtain their confirmation regarding their account balances and the same have been verified by competent authority.

## 3.3 INTERNAL CHECK—PREPARATION OF CHECK-LISTS

While evaluating the internal check system in an organisation an auditor often prepares a check list of important criteria and examines whether the system adheres to them. Although these criteria may differ from organisation to organisation, the following general considerations should always form part of a check list.

(i) No single person should be given control of the total part of a particular work independently.

(ii) The duties of the employees should be changed from time to time without previous notice so that the same employee does not perform the same work for a longer period of time.

(iii) Compulsory leave should be given to the employees every year.

(iv) Persons having physical custody of assets should not have any access to the books of accounts.

(v) For the prevention of cash loss or misappropriation of cash, mechanical devices, like automatic cash register, should be used.

(vi) The administrative and financial power should be distributed very judiciously among different officers and the manner in which they are actually executed should be reviewed periodically.

(vii) Procedures should be laid down for the periodical verification and testing of different sections of accounting records to ensure that they are accurate.

(viii) A strict supervision should be exercised to ensure that the prescribed internal checks and procedures are fully operative.

(ix) No staff members of the business should be relied upon too much. The system must provide for an automatic checking of the work of every employee by another employee.

## 3.4 LIABILITY OF THE STATUTORY AUDITOR FOR RELYING ON INTERNAL CHECK SYSTEM

In an organisation, an auditor is appointed to authenticate the books of accounts and final financial statements based on all available evidences. He is also to express an unbiased opinion on the exhibition of true and fair view of the financial performance and financial state of affairs through the income statement and the balance sheet respectively. Thus keeping in mind such an objective the auditor needs to decide the extent of examination that he should conduct to arrive at any conclusion. The auditor, in this context, can resort to either detailed checking or test checking. Detailed checking refers to the examination of books of accounts in detail. Test checking, on the other hand, is the technique of checking some transactions selected as sample from the group of transactions and drawing conclusion on that basis, taking sample transactions selected to be the representative of the remaining transactions. Detailed checking is time consuming as well as laborious whereas test checking relieves the auditor from such

pain. Thus, in actual practice, often the auditor is found reporting to test checking, provided the internal check system is satisfactory.

Reliance on an effective internal check system and thereby streamlining the audit process enables the auditor to devote more time in examining the critical areas of accounting including valuation of closing stock, valuation of assets and liabilities, determining the reasonableness of provisions etc.

However such reliance simultaneously increases the risk of the auditor. This is because even a sound internal check system can not guarantee the non-existence of any error or fraud in the accounts. Thus when the auditor applies test checking instead of a detailed checking, there is every possibility that any such error or fraud remains undetected. In such a situation the auditor cannot escape his responsibility on the ground that he relied upon the existing internal check system of the organisation, rather he will be held liable for negligence in his duty. This was also held in the famous Case Law of *Mc. Bride Ltd* vs. *Rooke and Thomas, Canada* (1941). In this case honourable judge concluded that an auditor cannot be relieved from his liability for non-detection of material errors and frauds simply on the ground that he depended on the internal check system.

Thus the auditor should always keep in mind that resorting to test checking by relying on internal check system of the organisation no way reduces the liability of the statutory auditor. If any error or fraud is detected afterwards he will be held liable for being negligent in his duty. Therefore if an auditor relies on internal check system and tries to make his work short and simple, he must do so at his own risk.

## 3.5 INTERNAL CHECK SYSTEM FOR SOME TRANSACTIONS

### 3.5.1 Cash Sales of a Departmental Store

The internal check system in respect of cash sales of a departmental store includes the following steps:

(i) There should be a separate sales counter for different products.
(ii) Each sales counter should have separate salesman.
(iii) The salesman neither can receive any cash nor can deliver goods to customers. He can prepare cash memos only.
(iv) Each salesman should be given separate cash memo book and each cash memo must have four copies.
(v) Cash memo should contain pre-printed serial number.
(vi) Salesman at the time of sales should prepare the four cash memos and authenticate it by signing.
(vii) Cash memo prepared by the salesman should be cross checked by another official.
(viii) Out of the four copies of a cash memo prepared by the salesman, three copies to be given to the customer and one copy to be retained by him to prepare sales summary.

(ix) Customer has to make payment in cash at the cash counter.

(x) Cashier after receiving the payment should retain two copies of the cash memo and will return one copy to the customer after affixing received stamp.

(xi) Cash sales need to be recorded by the cashier in the cash register to know the actual figure of cash sales at the end of each day.

(xii) One copy of total cash sales would be sent to the delivery department.

(xiii) There is usually a separate delivery department from which goods are delivered to the customers on producing their copy of cash memo having received stamp.

(xiv) At the time of exit, the perforated portion of customer's copy of cash memo would be taken by the gatekeeper and be given to the authority.

(xv) At the end of the day, summary of cash sales will be prepared by all staffs concerned and to be submitted to the manager

(xvi) Cash receipt needs to be deposited by head cashier on the following day.

### 3.5.2 Salaries and Wages of a Manufacturing Concern

The internal check system in respect of salaries and wages of a manufacturing concern includes the following steps:

#### A. Recording of Time

(i) There should be preferably a separate department known as 'time office' to record attendance, working hours of employees.

(ii) There should be a time recording clock at the factory entrance and at each department. As per requirement, the two times recorded can be tailed for a worker.

(iii) Separate file of each worker containing name, date of birth, date and terms of appointment, wage rate, etc. should be maintained.

(iv) Job cards recording the time spent by individual workers on each job need to be maintained and may be verified with attendance register, for a worker if required.

(v) Overtime paid should be approved by the authority.

(vi) Appointment, promotion, retrenchment should be supported by office order.

(vii) For piece rate system, the units produced by each worker should be recorded in piece card.

#### B. Wage Sheets Preparation

(i) Wage sheet has to be prepared by the wage department. It should be ensured that work should be distributed in such a way that the work of one gets automatically checked by another.

(ii) It should also be ensured that there is rotation of jobs. One employee should not do the same job for a longer period of time.

(iii) Wage sheets prepared has to be initialed by the person preparing it.

(iv) The variation in wage rate should be supported by a reconciliation statement.
(v) Computers should be used to reduce chances of error in calculations.

**C. Wage Disbursement**

(i) Exact amount shown in the wage sheet are to be withdrawn from the bank.
(ii) Wage sheet should be verified by the internal auditor.
(iii) Pay packet must bear the name of individual employees.
(iv) Worker should put either thumb impression or sign at the time of receiving wages.
(v) Wages should be paid in the presence of foreman or supervisor.
(vi) Unpaid wages, if any, should be recorded in respective register.
(vii) Unclaimed wages, if any, should be deposited in the bank after a certain period.
(viii) Name of workers in unpaid wages register should be checked to ensure that same name don't appear every time.
(ix) Separate list of casual workers need to be maintained.
(x) Individual responsible for preparation of wage sheet should not make payment himself.
(xi) Surprise visit of higher officials is required sometimes to prevent chances of fraud.

### 3.5.3 Stock

The internal check system for stock includes the following:

(i) Different stock levels need to be fixed.
(ii) Purchase requisitions are to be placed by the storekeeper as stock reaches re-order level.
(iii) Neither excess stock nor shortage is desirable, so an optimum level to be maintained.
(iv) Goods to be received by the receiving department and four copies of goods received notes need to be prepared. It should be given to accounts department, purchase department and stores department.
(v) Finished goods received are to be recorded in finished goods ledger.
(vi) Receiving department after checking the goods received should send it to the stores department.
(vii) Goods should be insured while in store.
(viii) Goods issued to production should be properly accounted for.
(ix) If any goods are returned, it should also be properly accounted for.
(x) Bin card shows the details of goods received and issued should be maintained for each item.
(xi) Accounts department should maintain the store ledger.
(xii) Stock taking should be done to check discrepancy, if any, between actual stock figures and figures as per the store ledger.
(xiii) Under ABC analysis of inventory control, it should be checked for A category items whether there is an obsolete or slow moving stocks.

(xiv) Accounting treatments of slow moving, obsolete items are done by the management.

(xv) It should be verified that the closing stock of a particular year becomes the opening stock of the next year.

### 3.5.4 Receipts of a Cinema Hall

The main sources of income of a cinema hall include sale of tickets, receipts from advertisement, receipts from restaurant attached with the hall, rent from shops attached with the hall, etc. Thus the internal check system should include the following:

#### A. Sale of Tickets

(i) Entry to hall must be allowed through printed purchased tickets only. Only the hall manager should have the right to issue free pass.

(ii) Tickets should have serial numbers.

(iii) Preparation of statement of tickets sold should be mandatory to verify it with the actual cash receipts.

(iv) Statement of tickets sold should be authenticated by booking clerk and cashier.

(v) Cash receipts should be entered in the cash book.

(vi) Cash receipts should be deposited in the bank on the next day.

(vii) Unsold tickets need to be preserved safely in the custody of a competent authority.

#### B. Advertisement Receipts

(i) Tariff rates of advertisements should be determined on the basis of time.

(ii) All receipts must be in a/c payee cheques only.

(iii) Written contract for each advertisement should be there.

#### C. Receipts from Restaurants

(i) When cash is received from sales, it should be recorded in a rough cash book before posting it to the final cash book. At the end of each day, the cash sales recorded should be verified with physical cash first before final posting to main cash book.

(ii) Amount of sales recorded daily should be authenticated by at least two responsible officers.

(iii) All cash sales should not be handled by one staff, and the work load should be distributed.

#### D. Rent from Shop (if any)

(i) If there is any shop attached to the hall, the rent to be paid to the hall by the shopkeeper should be in a/c payee cheque issued in the name of the hall.

(ii) After receiving the cheque, the hall should record it in main cash book and then deposit the same into bank.

(iii) If any cheque takes time to get cleared then the matter should be probed into by hall authority.

(iv) Finally, preparation of bank reconciliation statement, preferably on monthly basis, should be mandatory to tally cash and bank balance.

### 3.5.5 Receipts of a Nursing Home

The main sources of income of a nursing home include rental charges of rooms, hire charges of ambulance by patients, operation theatre hire charges, doctor's fees, medicine charges, etc. The internal check system of a nursing home is discussed below:

(i) Bed charges should be determined by the management on the basis of facilities available in the room like television, air condition, etc.

(ii) A separate file should be maintained in the name of each patient admitted in the nursing home.

(iii) The file should contain detail information regarding the patient, i.e a complete information sheet regarding the patient covering different aspects, like admission date, operation theatre charges, ambulance charges, pathology charges, bed charges, date of discharge, etc. should be prepared and maintained by the senior staff of nursing home authority.

(iv) The details of requisitions for medicines and the doctor's consultation availed should be properly maintained by the nursing home authority.

(v) Operation theatre charges should be fixed on the basis of hours.

(vi) Ambulance hire charges should be determined on the basis of km.

(vii) At the time of discharge of the patient, bill should be prepared by the responsible officer stating the expenses incurred by patient party. Four copies of bill should be prepared, out of which three should be given to the patient party, one to be preserved by the nursing home.

(viii) The patient party, on receipt of the bill, should make payment in the cash counter. The cashier should retain one copy and return other two to the patient party after affixing received stamp.

(ix) The entries in the cash book on the cash receipt from the patient party to be recorded by clerical staff of accounts department and not by the cashier.

(x) The copy of bill to be given to the attending staff of the individual patient before discharge.

(xi) In case, patients have health insurance, the entire expenses incurred for treatment is reimbursed by the insurance company. In that case, cashless admission is made, but necessary authorised letter should be obtained from the insurance agent through the relative of the patient. The amount received by means of reimbursement should be noted down under respective heads in the bill. The accounting treatment of the reimbursement should be made by the responsible officer.

## 3.6 INTERNAL CONTROL

### 3.6.1 Definition of Internal Control

Internal control system provides a measure for the management to obtain information, protection and control which are essentially crucial for the running of a business organisation successfully.

In other words, internal control is the process, effected by an entity's Board, management, and other personnel, designed to provide reasonable assurance regarding achievement of the objectives in the following categories:

(i) Reliability of financial reporting,
(ii) Effectiveness and efficiency of operations, and
(iii) Compliance with applicable laws and regulations.

The Institute of Chartered Accountants of India defines internal control system as, *"plan of organisation and all the methods and procedures adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of frauds and errors, the accuracy and completeness of the accounting records and the timely preparation of reliable financial information. The system of internal control extends beyond those matters which relate directly to the functions of the accounting system."*

So, internal control system is the total system of control established by the management of an organisation so as to ensure achievement of organisational objective effectively and efficiently.

### 3.6.2 Scope of Internal Control

The scope of internal control system is vast. It comprises both administrative control as well as accounting control.

#### A. Administrative Control

Administrative control refers to the control system that ensures adherence to management's policies, rules, regulations and thereby maintains operational efficiency. Administrative control is associated with the decision-making process which is concerned with management's authorisation of transactions. In other words, it relates to the management function that is directly linked with achieving the organisational objective. Administrative control relates to the production process, quality control, operational efficiency, statistical analysis, pricing strategies, marketing strategies, human resource management, performance analysis, etc.

#### B. Accounting Control

Accounting control, also known as financial control, refers to the control system which ensures recording of transactions in the books of accounts adhering to the established accounting policies and principles. It also refers to confirming the fact that transactions recorded in the books of accounts are genuine, they pertains to the organisation and are properly

authorised. To ensure reliability of accounting data and ensuring adoption of generally accepted accounting principles (GAAP) and now the very recent International Financial Reporting Standard (IFRS) are the prime objectives of accounting control. Accounting control relates to maintaining proper books of accounts, recording transactions timely, checking arithmetical accuracy of books of accounts, rotation of duties of staffs, etc. Accounting control is again divided into two sub-sections namely (a) Internal Check and (b) Internal Audit.

### 3.6.3 Objectives of Internal Control

In an organisation internal control is the holistic and minutely planned control system whose prime objective is to conduct the activities of the organisation in an orderly manner. However within this prime objective, the specific objectives are as follows:

#### A. Authorisation

An important objective of internal control is to ensure that all transactions are approved by the responsible personnel in accordance with specific or general authority.

#### B. Completeness

Another objective of internal control is to ensure that the books of accounts is completed in all respect and no valid transaction has been omitted from the accounting records.

#### C. Accuracy

An important objective of internal control is to ensure that all valid transactions are accurately recorded, consistent with the originating transaction data and information is recorded in a timely manner.

#### D. Validity

Internal control should also ensure that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorisation.

#### E. Physical Safeguards and Security

It must ensure that access to physical assets and information systems are controlled and properly restricted to authorised personnel.

#### F. Error Handling

Internal control should ensure that errors detected at any stage of processing receive prompt corrective action and are reported to the appropriate level of management.

#### G. Segregation of Duties

Another objective of internal control is to ensure that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures related to processing of the same transaction.

In this respect SA-315 on Risk Assessment and Internal Control, advocates the following objectives of internal control:

(i) To ensure that transactions are executed as per management's authorisation
(ii) To ensure that transactions are recorded in proper way to facilitate preparation of financial information for maintaining record of assets.
(iii) To ensure that assets are protected from unauthorised use, sale, etc.
(iv) To ensure that assets are verified at frequent intervals.

### 3.6.4 Features of Internal Control

The important features of internal control are:

**(i) Control Environment** The term 'control environment' refers to a company's attitude toward internal control. Known as "tone-at-the-top," the control environment is a necessary condition for effective internal control, because even the best-designed systems can be thwarted, if the management overrides the controls that are in place. Indicators of an effective control environment include having a whistleblower hotline or discipline policies that take violations of internal control seriously. Management override of controls or shortcuts are signs that the control environment may be deficient.

**(ii) Risk Assessment** Risk assessment is the identification of points in the company's business processes where internal control is important. Sometimes this is referred to as the "what could go wrong?" stage. In completing a formal risk assessment, a company would examine the business cycles in great detail. This often includes flow-charting transactions cycles and describing business processes using narratives.

**(iii) Information and Communication** The information and communication component of internal control involves the process of gathering and disseminating information throughout the organisation. Effective information and communication will include business systems that gather information related to internal control and management that uses this information to support employees in doing their job. It should also be apparent through employee handbooks and orientation processes so that employees receive communications related to ongoing control efforts periodically throughout their employment.

**(iv) Monitoring** Monitoring is the ongoing feedback mechanism that ensures that internal control systems that are effectively designed remain that way. Effective monitoring includes ongoing testing of existing control activities and procedures to follow when business processes change. This also includes a process to communicate ineffective internal control upward so that company management can understand when changes need to be made in a timely manner.

**(v) Control Activities** Control activities are the specific activities performed by the company personnel to ensure that internal control is effective. These activities are

designed to address issues found in the company's risk assessment, then implemented and tested for operating effectiveness as part of the monitoring function. The results of this testing are then communicated to employees and management. It is important to remember that while control activities appear to be the hub of effective internal control, if the control environment is not conducive to effective internal control, even the well-designed control could be ineffective.

### 3.6.5 Limitations of Internal Control

No matter how well internal controls are designed, they can only provide a reasonable assurance that objectives have been achieved. Some limitations are inherent in all internal control systems. These are as follows:

**(i) Judgment** The effectiveness of controls will be limited by decisions made with human judgment under pressure to conduct business based on the information at hand.

**(ii) Breakdowns** Even well designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerised information systems.

**(iii) Management Override** High level personnel may be able to override prescribed policies and procedures for personal gain or advantage. However, this should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.

**(iv) Collusion** Control systems may become ineffective due to employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.

**(v) Costly System** The total system of internal control often turns up to be very costly. If the losses incurred on account of errors and frauds exceed the benefits of internal control system, then it becomes redundant for the organisation.

**(vi) Control Over Common Business Activities** Internal control system is concerned with common business activities only. It is difficult to follow a particular system for specific business activities.

### 3.6.6 Evaluation of Internal Control System by the Auditor; the Purpose

An auditor is mainly concerned with the evaluation of the internal control system in force so that he may be able to know:

(i) Whether mistakes, errors and frauds are likely to be located in the ordinary course of business?

(ii) Whether an effective internal auditing department exists or not?

(iii) How far and how adequately the management is discharging its function in so far as correct recording of transaction is concerned?

(iv) How extensive examination he should carry out in different areas of accounting?
(v) How far administrative control has a bearing on his work?
(vi) What should be the appropriate audit programme in existing circumstances?
(vii) To what extent reliability can be placed on the reports, records and the certificates of the management.
(viii) Whether some suggestion can be given to improve the existing control system.

Therefore, we can conclude by saying that internal control is a broad term which includes internal check, internal audit, and other forms of control.

### 3.6.7 Evaluation of Internal Control System by the Auditor; the Process

Internal control system is introduced by the management of an organisation with an objective to ensure the conduct of the business smoothly, effectively and efficiently. Management is responsible for recording transactions and safeguarding the assets of the organisation. So, there should be an appropriate internal control system to ensure effectiveness of accounting system. Internal control system of an organisation depends on the size and nature of business. It is the duty of the auditor to express an opinion regarding the truth and fairness of financial statements and the authenticity of the financial statements depends on the effectiveness of internal control system of the organisation. An auditor can adopt test checking instead of detailed checking depending on the effectiveness of the prevailing internal control system of the organisation. This doesn't imply that an auditor can escape his liability if any fraud or error remains undetected due to adoption of short-cut technique. Before relying on the internal control system of an organisation, it should be evaluated to assess its effectiveness and it is done in two steps. They are:

- Understanding the internal control system
- Assessment of control risk

#### A. Understanding the Internal Control System

Understanding the internal control system prevailing in an organisation is essential to know how much effective and efficient it is. To understand the effectiveness of internal control system, information relating to administrative control and accounting control is necessary. There are various sources from which such information can be collected like:

**(i) Detailed Records Maintained by the Auditor** This implies the records maintained by the auditor relating to the system prevailing in the organisation on the basis of his examination and observation. However, this is suitable only for small organisations where any formal internal control is generally absent. In large organisations it suffers from various limitations like difficulty in identifying the weakness of the prevailing system, difficulty in grasping the system, necessity for amending the records due to any reallocation of duties.

**(ii) Check List** Check list is a set of questions or instructions with respect to a specific function of the organisation which is answered by the audit staff. The questions or instructions in the check list are generally in the form of 'yes', 'no' or 'not applicable' and are related only to the internal control system within the organisation. The audit staff who answers the questions in the check-list, also puts his signature against the questions or instructions at the time of his response. The auditor evaluates the effectiveness of internal control system by studying the complete check list. A few internal control check list questions are - 'Is there a purchase committee?', 'Are all purchases made through inviting tenders?', 'Are the purchases made through written purchase orders?' 'Who is responsible to place purchase order?', 'Does the same person receive the stock, handle it and record it in the books?'

**(iii) Internal Control Questionnaire** Internal control questionnaire is the set of questions relating to the internal control system of the organisation. Internal control questionnaire is prepared by the auditor. The answers are to be given in 'yes', 'no' or 'not applicable'. However, unlike internal control check list these are given to the client with an objective to obtain necessary information relating to the system of the organisation. The answer 'yes' indicates satisfactory and 'no' indicates there is some gap. There may also be some space in the questionnaire for sufficient explanation relating to the answer 'no'. The objective of preparation of internal control questionnaire is to obtain necessary information directly from the management or the client to judge its effectiveness.

In order to be effective, internal control questionnaire should contain questions pertinent to the internal control system only, it should be simple and should be revised from time to time, the questions should be specific, and above all, it should cover all the aspects of internal control.

### B. Assessment of Control Risk

Control risk refers to the risk relating to the internal control system of the organisation. The internal control system of the organisation may be effective and efficient, but still there is probability of some material misstatements that cannot be eliminated. So evaluation of control risk is necessary to assess the risk associated with the internal control system. To assess such a risk, there are some procedures like:

(i) Examination of documents relating to transactions so as to ensure internal control system being effective.
(ii) Inquires and observations to ensure that transactions are authorised by competent authority.
(iii) Rechecking and recasting of account balances, if necessary.

If from the control risk assessment it is found that there is very high chance of material misstatements in the financial statements, then the auditor should not rely on the internal control system, but if it is found that there is no chance of material misstatements in the

financial statement, then the auditor can rely on the internal control system of the organisation for his audit work. If the auditor suspects the chances of material misstatements in the financial statement after control risk assessment, he should go for the detailed checking. It should be remembered that relying on internal control system and adopting test checking do not reduce the liability of the auditor if any fraud or error remains undetected.

### 3.6.8 Evaluation of Internal Control System by an Auditor; the Methods

The following are the methods of evaluating internal control system of an organisation:

(i) **Inquiry** The auditor may directly communicate with the employees and officials of the organisation to judge the efficiency and effectiveness of existing internal control system. For this purpose, internal control questionnaire can be used. Based on the responses by the clients, auditor will try to assess the effectiveness of internal control system.

(ii) **Observation** Auditor himself may observe the activities within the organisation. He may visit office or may be present at stores without prior notification.

(iii) **Verification of Documents** Auditor may try to assess the internal control system by going through the manuals, official documents, charts made available to him.

(iv) **Flow Chart** By The auditor may also prepare a flow chart of the existing internal control system to understand the inter-relationship between various activities.

## 3.7 COMPARISON BETWEEN INTERNAL CONTROL AND INTERNAL CHECK

| Items of Comparison | Internal Control | Internal Check |
|---|---|---|
| Nature | Internal control system is the whole system of control. | Internal check is only a part of internal control. |
| Scope of work | It exercises control over all the areas of a function. | It is concerned with the work allocation only. |
| Function | Implementation of internal control is the responsibility of the management staff. | Internal check can be carried out by the ordinary staff. |
| Importance | It is concerned with operational efficiency, productivity and profitability of the organisation. | It is mainly concerned with record keeping and accounting reports. |
| Flexibility | It deals with overall control of the organisation with flexibility. | It is comparatively less flexible. |
| Internal elements | Internal control system includes internal check, internal audit and administrative control. | It has no internal element. |

## 3.8 INTERNAL CONTROL IN A COMPUTERISED ENVIRONMENT

Internal control system in an organisation which is largely computerised should differ significantly from that of an organisation which is still following manual record keeping. This is because while application of computers significantly makes the tasks easy, it also increases the risk substantially. Thus an auditor should be extra cautious while evaluating internal control in a computerised environment.

The two main categories of internal control in a computerised environment are application controls and general controls.

### 3.8.1 Application Controls

These are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

Application controls ensure that transactions occurred, are authorised and are completely and accurately recorded and processed. Application controls apply to data processing tasks such as sales, purchases and wages procedures and are normally divided into the following categories:

#### A. Input Controls

The most common example of programmed controls over the accuracy and completeness of input are edit (data validation) checks when the software checks that data fields included on transactions by performing:

- reasonableness check, e.g., net wage to gross wage
- existence check, e.g., that a supplier account exists
- character check, e.g., that there are no alphabetical characters in a sales invoice number field
- range check, e.g., no employee's weekly wage is more than $2,000
- check digit, e.g., an extra character added to the account reference field on a purchase invoice to detect mistakes such as transposition errors during input.

When data is entered via a keyboard, the software will often display a screen message if any of the above checks reveal an anomaly, e.g. 'Supplier account number does not exist'.

#### B. Processing Controls

An example of a programmed control over processing is a run-to-run control. The totals from one processing run, plus the input totals from the second processing, should be equal to the result from the second processing run. For instance, the beginning balances on the receivables ledger plus the sales invoices (processing run 1) less the cheques received (processing run 2) should be equal to the closing balances on the receivable ledger.

#### C. Output Controls

Batch processing matches input to output, and is therefore a control over processing and output. Other examples of output controls include the controlled resubmission of rejected transactions or the review of exception reports (e.g. the wages exception report showing employees being paid more than $1,000).

#### D. Master Files and Standing Data Controls

Examples include one-for-one checking of changes to master files, e.g., customer price changes are checked to an authorised list. A regular printout of master files such as the wages master file could be forwarded monthly to the personnel department to ensure employees listed have personnel records.

### 3.8.2 General Controls

These are procedures that establishes a structure of overall control to achieve the overall objectives of internal control. General controls include the following:

#### A. Management Control

This control excercise focuses on the policies and procedures relating to the control functions and ensures appropriate segregation of various functions such as preparation of input transaction programming and computer operations.

#### B. Computer Operation Control

This control excercise is generally designed to control the operations of the system. The objective of this control is to ensure that systems are used for authorised purposes only, are accessed only by the authorised personnels, run only the authorised programs and detect and correct any error quickly.

#### C. System Software Control

This control excercise aims to ensure authorisation, testing, approval and documentation of new system softwares.

#### D. Data Entry and Program Control

This control excercise ensures that entry of transactions in the computer system is duly authorised, only authorised personnel are allowed to make the entry, proper back-up of data is maintained, lost data can be recovered and there is offsite processing arrangements in case of emergency.

## 3.9 MEANING OF INTERNAL CONTROL QUESTIONNAIRE (ICQ) AND PREPARATION OF ICQ

Internal control questionnaire (ICQ) is a comprehensive and well structured series of questions concerning internal control. It is prepared by the auditor for collecting information about the

existence, operation and efficiency of internal control in an organisation. It is the most widely used technique of evaluation of internal control. Before embarking on audit, the auditor frames the questionnaire covering important areas of operation, namely, purchase sales, stock keeping, wage payment, etc. Each question in the questionnaire is set with the aim of assessing strength of internal control at every stage of an operation.

The questions range from the system of authorisation, flow of transaction, documents used in the flow, recording of transactions, division of labour aiming at internal check, handling of assets, reporting of transactions to the management and review of operations. Generally questions are so set that a 'Yes' answer indicates a satisfactory position and 'No' answer suggests deficiency in the control system. In case of 'No', answer provision is also made for further explanation or details. In case of the question not relevant to the business, 'not applicable' reply is given.

The questionnaire is sent by the auditor to the client with the request to get it filled up by some responsible officer(s). After going through the answers, if some inconsistencies or incongruities are noticed, the auditor should discuss the matters with the concern officers. The auditor then reports the deficiency to the management and suggest for improvement in the internal control system.

### 3.9.1 General Considerations before Preparing the Internal Control Questionnaire

Some relevant aspects to be considered while framing the internal control questionnaire includes the following:

(i) The questionnaire should be revised, updated and reviewed from time to time.

(ii) The questionnaire should try to cover every aspect of internal control system of the organisation.

(iii) If there is any change in the legal affairs relating to the organisation, that should be incorporated in the questionnaire.

### 3.9.2 Advantages of Internal Control Questionnaire

Internal Control Questionnaire offers the following advantages:

(i) Internal control system can be assessed easily through preparation of the questionnaire.

(ii) Weak areas in respect of internal control can be identified easily and improvements can be suggested accordingly.

(iii) It facilitates preparation of audit programme. Based on the questionnaire he can decide whether to go for a detailed checking or can depend on test checking.

(iv) It may act as an evidence that audit work has been done with due care.

### 3.9.3 Disadvantages of Internal Control Questionnaire

Internal Control Questionnaire suffers from the following limitations:

(i) It may not cover all the aspects of internal control, and in that case, there is a chance that internal control system assessment may not reveal the actual picture.
(ii) Sometimes it may be difficult sometimes to give all answers in 'yes' or 'no' form.

### 3.9.4 Specimen of Internal Control Questionnaire

**Table 3.1:** Example of the Structure of Internal Control Questionnaire

| | Yes | No | Not Applicable | Remarks |
|---|---|---|---|---|
| Question 1 | ✓ | | | |
| Question 2 | | ✓ | | |
| Question 3 | | | ✓ | |

**A. Salaries and Wages**

(i) Is there any separate department for salaries and wages?
(ii) Is job rotation frequent in the organisation?
(iii) Who is the competent authority for appointment, loan sanction, pay revision, discharge of employees, overtime?
(iv) Are records maintained in matters of appointment—terms and conditions, pay structure, age of retirement, date of resignation or termination of service, specimen signature and photograph?
(v) Are proper records maintained for the piece work and time work?
(vi) Are time cards maintained and approved by the time keeper and the foreman?
(vii) Are job cards maintained and similar to the attendance record?
(viii) Is the staff authenticating records on shop floor and wage department different?
(ix) Who does prepare the payroll?
(x) Is it computerised or prepared manually?
(xi) What is the procedure of preparation of payroll – is it prepared by a single staff?
(xii) Are the name of employees and their payment rates verified with the payroll?
(xiii) Is there a system of verifying payment rates in the wage sheet with the payroll at periodic intervals?
(xiv) Is the payroll authorised by the responsible officer?
(xv) Is the payment made in 'A/C Payee' cheque?
(xvi) Is the cheque drawn for exact net amount?
(xvii) Are salaries and wages paid after making necessary deductions?
(xviii) Are wages paid on the fixed date, time and in the presence of witness?
(xix) Is there any rule, regulation regarding the treatment of unclaimed wages?
(xx) Is the payment of unclaimed wages authorised by the responsible officer?

(xxi) Does another person have the authority to draw salary or wages on behalf of one employee?
(xxii) Are the payments of pension authorised by the competent authority?
(xxiii) Are the payments of pension checked with the life-certificate of the pension holder?

**B. Purchase and Creditors (Cash and Credit)**

(i) Is there a separate department for purchase?
(ii) Are tenders invited before placing orders?
(iii) Are purchase requisitions prepared?
(iv) Are purchases made on the basis of a written order?
(v) Are purchase order forms serially numbered?
(vi) Is the purchase order form, a standard one?
(vii) Does the purchase order form contain relevant fields only?
(viii) Is there a purchase committee to execute purchase transactions?
(ix) Are the purchase order file securely preserved?
(x) Is the purchase order authorised and approved by responsible officers?
(xi) Is the copy of the purchase order sent to the accounts department, receiving department and stores department?
(xii) Are the materials inspected on being received?
(xiii) Does the receiving department communicates with the purchase department and the accounts department on receipt of the material along with the report of inspection?
(xiv) Is the challan on purchase of material verified with the purchase order?
(xv) If credit purchases are made, are the invoices verified with the purchase orders and challans?
(xvi) Are the invoices approved by the responsible officer?
(xvii) Do all the invoices bear stamps to avoid duplication?
(xviii) Is there a system of inter-unit purchase?
(xix) Is the purchase ledger maintained manually or computerised?
(xx) Is the payment made in a/c payee cheque?
(xxi) If there is inter departmental transfer, then is the transfer priced at cost or invoice price?

**C. Sales and Debtors (Cash and Credit)**

(i) Are there any standard price lists of commodities?
(ii) Are there any prices which vary from the standard price lists, if so are they approved?
(iii) Are orders placed by the customers in written form?
(iv) Is there any ceiling of credit for credit sales?
(v) If there is any credit limit, then is it approved by the responsible authority?
(vi) Is the credit limit reviewed from time to time?

(vii) Are sales made to customers at a discounted rate?
(viii) Are the goods despatched along with despatch notes?
(ix) Do the despatch notes contain serial number?
(x) Are the despatch notes prepared by staffs other than sales department and accounts department?
(xi) Is acknowledgement obtained from customers after receipt of goods?
(xii) Are orders placed by customers marked after they are despatched?
(xiii) If there is any loss due to shortage, breakage or while in transit, is the credit given to customers to make up the losses tallied with the insurance claim?
(xiv) Are sales invoices numbered?
(xv) Are invoices verified with prices, terms of payment, etc?
(xvi) Are sales entries made in the sales day book?
(xvii) Are details of sales maintained by other than accounts department?
(xviii) If a cheque given by a customer is dishonoured, is it notified to sales department, customers' section?
(xix) Is the customer communicated on dishonour?
(xx) Does the receiving department verify the weight and number of goods returned by customers?
(xxi) Are sales return notes sent to accounts department, sales department and customer returning the goods?
(xxii) Are the goods returned included in the stock?
(xxiii) Is the credit note prepared on return of goods and communicated to the customer?
(xxiv) Are credit notes numbered?
(xxv) Is the credit note authorised by the responsible officer?
(xxvi) Are the credit notes tallied with the sales return notes?
(xxvii) Are the prices and calculation of the credit notes verified with the sales return notes?
(xxviii) Is the sales ledger tallied with the general ledger?
(xxix) Is the sales ledger balanced?
(xxx) Is the credit period allowed to the debtors reviewed from time to time?
(xxxi) Are balance confirmation obtained from the debtors from time to time?
(xxxii) Does the organisation have any provision for writing off bad debts?
(xxxiii) Does the organisation take actions for the recovery of bad debts?

## 3.10 INTERNAL AUDIT

### 3.10.1 Definition of Internal Audit

Internal audit is a dynamic profession involved in helping organisations achieving their objectives. It is concerned with evaluating and improving the effectiveness of risk management, control and governance processes in an organisation.

As per the committee of Internal Audit, formed by The Institute of Chartered Accountants of India, internal audit is, "*An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggesting improvements thereto and add value to and strengthen overall governance mechanism of the entity, including the entity's risk management and internal control system.*"

The Institute of Internal Auditors, USA (Standards for the Professional Practice of Internal Auditing) has defined internal audit as, "*Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process.*"

According to Walter B. Meigs, "*internal auditing consists of a continuous, critical review of financial and operating activities by a staff of auditors functioning as full-time salaried employees.*"

According to Taylor and Perry, "*Internal audit is a review of operations and records, sometimes continuously undertaken within a business by specially assigned staff.*"

Thus, internal audit is a continuous appraisal of the various operational activities of the organisation, apart from checking the books of accounts, by an employee of the organisation, preferably other than employees of accounts department, with an objective to report about the effectiveness of operations of the organisation.

### 3.10.2 Objectives of Internal Audit

As per SA-610, the broad objectives of internal audit are as follows:

(i) Review of accounting system and related internal control
(ii) Examination of financial and operating system
(iii) Examination of effectiveness and efficiency of financial control
(iv) Examination and verification of assets.

In specific the objectives of internal Audit include the following:

(i) Determine the accuracy and propriety of financial transactions.
(ii) Evaluate financial and operational procedures for adequacy of internal controls and provide advice and guidance on control aspects of new policies, processes systems.
(iii) Verify the existence of assets and ensure that proper safeguards are maintained to protect them from loss.
(iv) Appraise whether liabilities shown in the financial statement are genuine and have resulted from legitimate activities undertaken by the organisation.
(v) To conduct special investigation as per the instruction given by the management.
(vi) Determine the level of compliance with the policies and procedures, and government laws and regulations.
(vii) Evaluate the accuracy, effectiveness, and efficiency of the information processing systems.
(viiii) Determine the effectiveness and efficiency in accomplishing mission and identify operational opportunities for cost savings and revenue enhancements.

(ix) Coordinate audit efforts with, and provide assistance to, the Audit committee and external auditors.

### 3.10.3 Scope or Functions of Internal Audit

As per the Standard on Audit (SA)-610, 'Using the Work of Internal Auditors', the objectives of internal audit functions vary widely depending on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. Still the activities of the internal audit function must include the following in general:

(i) **Monitoring of Internal Control** The internal auditor may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.

(ii) **Examination of Financial and Operating Information** The internal auditor may be assigned to review the means used to identify, measure, classify and report financial and non-financial information, and to conduct specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(iii) **Review of Operating Activities** The internal auditor may be asked to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of the entity.

(iv) **Review of Compliance with Laws and Regulations** The internal auditor may be required to review compliance with laws, regulations and other external requirements, and with management policies, directives and other internal requirements.

(v) **Risk Management** The internal auditor may also required to assist the organisation by identifying and evaluating significant exposures to risk and offering suggestions for improvement of risk management and control systems.

(vi) **Governance** The internal auditor may also asked to assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability.

### 3.10.4 Advantages of Internal Audit

Internal audit offers a number of advantages, such as -

(i) **Assistance to Management** Internal audit assists management to execute various plans.

(ii) **Detection and Prevention of Errors and Frauds** Through internal audit, frauds and errors can be detected easily. Moreover the auditor can offer suggestive measures to prevent recurrence of these errors and frauds subsequently.

(iii) **Reduction in Wastage** Internal audit ensures reduction of wastage through identification of areas of weaknesses and deficiencies.

(iv) **Safeguarding Assets** Internal audit ensures whether proper measures have been taken to safeguard the assets. Internal auditor ensures proper security have been provided for the assets.

(v) **Increasing Efficiency** Internal audit helps in increasing the effectiveness of internal control system of the organisation and thereby helps in increasing the efficiency of the organisation.

### 3.10.5 Disadvantages of Internal Audit

Internal audit suffers from some limitations like:

(i) **Costly Affair** Internal audit is an expensive matter.

(ii) **Undue Influence** Internal auditor is the staff of the organisation. He may be influenced by other staffs of the organisation in course of his work.

(iii) **Unsuitable for Small Organisation** It is a costly affair. It is indeed difficult for small organisations to carry out internal audit.

(iv) **Less Qualified Person may be Appointed as the Internal Auditor** Since no such prescribed qualification is required for appointment of an internal auditor, it may happen that a less qualified person gets appointed as an internal auditor.

(v) **High Chances of Distortion** Internal audit report is prepared by the internal auditor who is basically a staff of the organisation. So, there is a chance that he may not always report the actual fact in order to save his colleagues in the organisation.

## 3.11 DIFFERENCES BETWEEN INTERNAL CHECK AND INTERNAL AUDIT

| Point of Distinction | Internal Check | Internal Audit |
|---|---|---|
| Nature | It runs automatically and concurrently with the execution of the transaction. | It is not an automatic process and works after the transaction takes place. |
| Function | One employee's work is automatically checked by the work of another employee. | It is a continuous review of records independently. |
| Activity | It prevents occurrence of errors and frauds. | It creates moral pressure on staff not to commit errors and frauds. |
| Staff | To run this system no separate set of staff is required. | To carry out internal audit a separate department is formed. |
| Objective | Prevention and early detection of errors and frauds is the objective of internal check. | To check the operational efficiency is the main objective of the internal audit. |
| Importance | It is concerned with carrying out work efficiently and effectively. | It is concerned with appraisal and ascertainment of reliability of records. |

## 3.12 DIFFERENCES BETWEEN INTERNAL CONTROL AND INTERNAL AUDIT

| Point of Distinction | Internal Control | Internal Audit |
|---|---|---|
| Concept | Internal control is the process, effected by an entity's Board of Trustees, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:<br>(i) Reliability of financial reporting,<br>(ii) Effectiveness and efficiency of operations, and<br>(iii) Compliance with applicable laws and regulations. | Internal audit is a dynamic profession involved in helping organisations to achieve their objectives. It is concerned with evaluating and improving the effectiveness of risk management, control and governance processes in an organisation. |
| Nature | It runs automatically and concurrently with the execution of the transaction. | it is not an automatic process and works after the transaction takes place. |
| Scope | Scope of the internal control system is very wide. | Internal audit is an important part of the internal control system. |
| Responsibility | Implementation of the internal control is the responsibility of the management staff. | Internal audit is executed by the internal auditor. |
| Presence | Internal control system presents in all departments. | A separate department is formed to execute internal audit. |

## 3.13 COMPARISON BETWEEN INTERNAL CONTROL, INTERNAL AUDIT AND INTERNAL CHECK

| Points of Distinction | Internal Control | Internal Audit | Internal Check |
|---|---|---|---|
| Definition | System of control introduced by management for running business activities smoothly. | Appraisal of operational, financial activities of the business to report on operations of the business. | It is a system in which work is distributed among the employees so that the work of one is automatically checked by another employee. |
| Objectives | Objective of internal control is to ensure progress of the organisation through organisational control. | To detect errors and frauds is the prime objective. | To ensure protection of assets and to maintain books of accounts correctly. |

(Contd.)

| Scope | Scope is wider compared to internal check and internal audit. | Scope is narrower. | Scope is narrower. |
|---|---|---|---|
| Responsibility | To introduce an efficient internal control system is the responsibility of the management. | Internal audit is the responsibility of the auditor. | Internal check is the responsibility of the accounts department. Nothing is mentioned regarding the responsibility of the management. |
| Flexibility | This system is flexible and can be changed with situation. | There is a predefined procedure and technique to be followed. | It is less flexible. Once implemented, remains stable. |
| Coverage | It is the total system of control | It is a part of the internal control. | It is a part of the internal control. |

## 3.14 LEGAL REQUIREMENT OF INTERNAL AUDIT

As per Section 138 of the Companies Act, 2013 read with Rule 13 of Companies (Accounts) Rules, 2014, certain classes of companies are required to appoint Internal Auditors who shall either be a Chartered Accountant, Cost Accountant or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company. The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely (a) "Every listed company" and (b) Private and unlisted public companies meeting "any" of the following criteria:

| Criteria | Unlisted Public Company | Private Company |
|---|---|---|
| Paid up share capital | Fifty crore rupees or more during the preceding financial year. | No share capital criteria. |
| Turnover | Two hundred crore rupees or more during the preceding financial year. | Two hundred crore rupees or more during the preceding financial year. |
| Outstanding loans or borrowings from banks or public financial institutions | Exceeding one hundred crore rupees or more at any point of time during the preceding financial year. | Exceeding one hundred crore rupees or more at any point of time during the preceding financial year. |
| Outstanding deposits | Twenty five crore rupees or more at any point of time during the preceding financial year. | No deposit criteria. |

## 3.15 RELYING UPON THE WORK OF INTERNAL AUDITOR

SA-610 (earlier AAS-7), issued by ICAI states that external auditor can use the work of internal auditor after evaluation of internal audit functions.

Accordingly, the following factors should be considered while determining the extent to which external auditor can rely on the work of internal auditor:

(i) whether internal audit is undertaken by outside agency or by a separate audit department within the entity.
(ii) the scope of internal audit, management action and the internal audit report.
(iii) experience and qualification of internal audit.
(iv) the technical compliance by internal auditor.
(v) authority vested on internal auditor and level of management to whom he is accountable.
(vi) whether professional care has been taken by the internal auditor in conducting audit work.

The above statements suggest the following features:

- The role of the internal auditor is determined by the management and differs from external auditor.
- External auditor should evaluated internal audit function to the extent it is relevant for determining nature, timing and extent of his compliance and substantive procedures.
- The responsibility of the external auditor cannot be reduced due to reliance on the work of the internal auditor.

Thus to conclude it can be said that, the external auditor can rely on the work of the internal auditor, but if any misstatements remain undetected, the external auditor will be held liable for negligence in his duty.

## SUMMARY

- Internal check is the process of arrangement of duties of various staffs of a business in such way that work of one is automatically checked by the next staff while performing their duties.
- The objectives of an internal check system include elimination of frauds and errors, ensuring smooth flow of work, ensuring reliability of information, detection of errors and frauds at an early stage, increasing reliability of financial data, ensuring careful and continuous work by staff.
- Internal control system is the total system of control established by the management of an organisation so as to ensure achievement of organisational objective effectively and efficiently.

- The objectives of internal control include authorisation, completeness, accuracy, validity, physical safeguards and security, error handling and segregation of duties.
- Internal control encompasses both administrative control as well as accounting control.
- Internal control questionnaire is the set of questions relating to the internal control system of the organisation. It is prepared by the auditor to assess the effectiveness of the internal control in the organisation.
- In a computerised environment internal control comprises of Application Controls and General Controls.
- Internal audit is a continuous appraisal of the various operational activities of the organisation, apart from checking the books of accounts, by an employee of the organisation, preferably other than employees of accounts department, with an objective to report about the effectiveness of operations of the organisation.
- An external auditor often relies on the work of an internal auditor.
- Though the external auditor can rely on the work of internal auditor, in case any misstatements remain undetected, he will be held liable for negligence in his duty.

## EXERCISE

### A. Short Answer Type Questions (2–4 marks)

1. What is Internal Check?
2. What is Internal Control?
3. What is internal Audit?
4. Define the term 'Internal Control Questionnaire'?
5. What is Internal Control Checklist?

### B. Medium Answer Type Questions (4–6 marks)

1. What do you understand by the term "Internal Check"? Has an auditor any responsibility in general thereto?
2. Explain the terms Internal Check, Internal Control and Internal Audit.
3. Discuss the difference between Internal Control System and Internal Check System. [*C.U. B.Com(H), 2008*]
4. Can an auditor, while performing his function as a statutory auditor, rely on the internal checking system? [*C.U. B.Com(H), 2003*]
5. "Internal Audit cannot replace Internal Check"— Explain. [*C.U. B.Com(H), 2004, 2007*]
6. To what extent can an auditor rely on internal audit report, while performing his function as a statutory auditor? [*C.U. B.Com(H), 2005*]
7. To what extent can a statutory auditor rely on internal audit report? [*C.U. B.Com(H), 2009*]

8. Discuss the objectives of "Internal Control" System.
9. What are the inherent limitations of Internal Control? Mention them.
10. Discuss the objectives of an effective system of internal control. [*C.U. B.Com(H), 2007*]
11. State the important factors to be considered by an auditor while reviewing the internal control system of an Insurance company. [*C.U. B.Com(H), 2008*]
12. Write short notes on Internal Check. [*C.U. B.Com(H), 2011*]
13. What is Internal Audit? Is it mandatory for all limited companies? [*C.U. B.Com(H), 2008, 2010, 2012*]
14. Can a statutory auditor check the books of accounts already audited by an internal auditor? [*C.U. B.Com(H), 2000*]
15. Internal audit cannot take the place of internal control system.—Explain. [*C.U. B.Com(H), 2006*]
16. Write short notes on Internal Control.
17. Distinguish between Internal Audit and Interim Audit. [*C.U. B.Com(H), 2014*]
18. Briefly state the general rules to be followed while preparing Internal Control Questionnaire (ICQ). [*C.U. B.Com(H), 2014*]
19. Distinguish between Internal Audit and Statutory Audit. [*C.U. B.Com(H), 2014*]

## C. Essay Type Questions (8–10 marks)

1. (a) Distinguish between Internal check and Internal Control System.
   (b) Can the statutory auditor rely upon the work of an internal auditor? Justify your answer mentioning relevant SA. [*C.U. B.Com(H), 2014*]
2. Prepare an Internal Control Questionnaire (ICQ) in respect of purchase of goods of a manufacturing concern. [*C.U. B.Com(H),* 2014]
3. Draft internal control questionnaires for the following audit areas: (a) Purchase and creditors, (b) Sales and Debtors and (c) Salaries and Wages.
4. What is Internal Check System? State its objectives. Write its differences with Internal Control System. [*C.U. B.Com(H), 2013*]
5. Define Internal Audit. Make a comparative discussion of it with internal control system. Can a Statutory Auditor complete his work relying upon the report of an Internal Auditor? [*C.U. B.Com(H), 2013*]
6. Suggest a suitable system of Internal Check in relation to payment of wage in a large manufacturing concern.
7. Outline a suitable system of Internal Check System for Cash Department of a large Departmental Store.
8. Suggest a set of rules you would recommend for the Internal Control over the purchase of raw materials of a large manufacturing concern.

9. Explain the methods of examination under internal control system.
10. (a) State the Fundamental Principles of Internal Control.
    (b) Discuss the limitations of internal Control System.
11. Detail the system of Internal Check you should expect: (a) In respect of wages payment in a manufacturing concern and (b) Receipts of Cinema Hall. Explain the methods of examination under internal control system.
12. Detail the system of internal check you would expect. (i) In respect of wages payment in a manufacturing concern. (ii) Receipts of a Nursing Home.
13. "In a good system of Internal Check, the work of one is checked indirectly by the work of another".—Explain the statement with examples.
14. "Internal Audit is not a substitute of Statutory Audit."—Explain the statement.
15. (a) Can the statutory auditor rely upon the internal audit system in carrying out his functions in statutory audit?
    (b) In case of his reliance what would be his responsibilities.
16. (a) Make a comparative study of Internal Check System, Internal Audit and Internal Control System.
    (b) Prepare an Internal Control Questionnaire of wage payments in a large manufacturing concern. [*C.U. B.Com(H), 2006*]
17. (a) What is Internal Control System? What are its objectives?
    (b) Prepare an Internal Control Questionnaire in relation to raw material purchase of a large manufacturing concern. [*C.U. B.Com(H), 2010*]

# 4 CHAPTER AUDIT SAMPLING AND ANALYTICAL PROCEDURE

## CHAPTER OUTLINE

**4.1** Audit Sampling
**4.2** Audit Procedures
**4.3** Analytical Procedure

## 4.1 AUDIT SAMPLING

### 4.1.1 Concept and Definition

In case of a large organisation with adequate internal control system in force, it is neither feasible nor desirable to verify each and every transaction to come to a conclusion relating to the disclosure of true and fair view of financial performance and the state of affairs. The auditor, in such a situation, should certainly apply partial checking to form his opinion. However, the success of part checking largely depends on appropriate sample selection. Hence, it is imperative that the auditor should have sufficient knowledge regarding sampling technique.

According to SA-530 on 'Audit Sampling' issued by ICAI, sampling in the context of auditing is the application of audit procedures to less than 100% of the items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis to draw a conclusion about the entire population. In other words, audit sampling is the process of selecting a limited number of transactions out of the total transactions of a given category (known as population) using a reasonable basis and applying the audit procedures on the selected transactions to form an opinion about the entire category.

### 4.1.2 Need or Importance of Audit Sampling

The need or importance of audit sampling is felt for the following reasons:

**(i) Reduces the Workload** Carefully executed sampling reduces the workload of the auditor without compromising the audit quality.

**(ii) Saves Time and Cost** Audit work based on selected transactions significantly saves time and cost.

**(iii) Evaluating the Effectiveness of Internal Control System** Auditor's decision with regard to the optimum sample size and method of selection is largely influenced by the outcome of internal control evaluation. In this process, any weakness of the internal control system, if identified, can immediately be brought to the notice of the management for necessary corrective actions.

**(iv) Dependable Results** Audit sampling based on statistical sampling methods produces results which are close to reality.

**(v) Allows More Time for Innovative Audit Procedures** Since audit sampling significantly reduces the requirement of routine checking of all items, an auditor gets more time to engage in innovative audit procedures like analytical procedure which is considered to be more effective in identifying irregularities.

### 4.1.3 Factors to be Considered for Audit Sampling

Designing an audit sample requires consideration of the following factors:

**(i) Objective of Audit** The auditor, while designing the audit sample, should consider the purpose to be achieved and the audit procedures or combination of audit procedures best suited for achieving such purpose.

**(ii) Nature of Population** The auditor must also consider the nature of the population, i.e. the degree of homogeneity of its items. Such knowledge will help the auditor to select an appropriate sample selection method.

**(iii) Adequacy of Internal Control** The auditor should also evaluate the adequacy of the internal control system. In the event of an inadequate or ineffective internal control system, the sample size should essentially be larger in order to be representative.

**(iv) Materiality of Items** Some items of the population may be so immaterial that any error associated with them will not materially alter the final results. Such items may easily be avoided to allow scope for material items to be included.

**(v) Sampling Risk** Audit sample must be so designed as to keep the sampling risk within the acceptable limit.

**(vi) Non-sampling Risk** The auditor must take due care to avoid any personal bias (known as non-sampling risk) while collecting and analysing the sample data.

**(vii) Tolerable Misstatement** It is the maximum permissible error limit (preferably in monetary units) that the auditor can accept and still expect that the audit sample will meet the audit objective. The lower the tolerable misstatement the higher will be the sample size and vice-versa.

## 4.1.4 Approaches to Sampling

There are basically two broad approaches or techniques of sampling. These are Statistical Sampling and Non-statistical/Judgemental Sampling. The decision whether to use statistical sampling or non-statistical sampling rests with the auditor himself and sample size is never a valid criterion to distinguish between the two. Moreover, the auditor should always remember that whatever be the sampling approach, the sample must be representative, otherwise the basic objective of sampling will remain unfulfilled.

### A. Non-statistical Sampling or Judgemental Sampling

Under this technique, the sample size and its composition are determined based on auditor's own experience and knowledge and no statistical tool is applied to select the sample. Therefore, sample selection criterion in this method may vary from organisation to organisation or from time to time.

This method is very simple and easy to execute. This does not require any specialised knowledge of statistics and hence, it is easy to understand. However, this method also has some limitations. It is unscientific and may not provide any logical sense while selecting an item in the sample and rejecting another. Moreover, it is completely based on auditor's own judgement and hence, may suffer from personal bias and lack of objectivity.

### B. Statistical Sampling

This approach is more scientific and does not depend on auditor's personal judgement. Rather, it applies mathematical laws of probability in determining the appropriate sample size in varying circumstances. This approach is extremely useful where the population to be tested has large number of similar transactions or where transactions require compliance testing.

Statistical sampling produces more accurate results and provides an objective basis of selection. However, proper application of this technique requires specialised knowledge on the part of the audit clerks.

## 4.1.5 Sample Selection Methods/Types of Sampling

Sample should be selected in such a manner that it becomes representative of the population from which it is being selected. There are several methods that fulfill this basic objective of sampling. These are discussed below:

### A. Random Sampling

In this method of sampling each item of the population or within a given group (popularly known as stratum) has a known chance of selection. Random sampling can again be of two types:

#### *Simple Random Sampling*

Under this method of sampling, each unit of the population has an equal chance of being selected in the sample. Here selection is normally done either by choosing a random number

manually from a random number table or allowing the computer programme to select a random number and then identifying the population unit that corresponds to the random number by using any predefined rule. However, this method essentially requires the population units to be reasonably homogeneous or similar in nature.

***Stratified Sampling***

This method requires a given heterogeneous population to be first divided into a number of sub-populations (known as stratum) with homogeneous items and then selecting equal or unequal proportion of items from each group to form a representative sample of reasonable size. For example, trade receivable balances may be divided into five groups as:

(i) Balances in excess of ₹ 500000
(ii) Balances in between ₹ 300001 to ₹ 500000
(iii) Balances in between ₹ 100001 to ₹ 300000
(iv) Balances in between ₹ 20001 to ₹ 100000
(v) Balances up to ₹ 20000.

The auditor may then decide to vouch all the transactions from the first group, 50% transactions of the second, 25% of third and fourth group and 5% transactions of the last group. Alternatively, if thought appropriate, he may pick up equal percentage of transactions from each group.

**B. Systematic/Interval Sampling**

This method requires selecting items using a constant interval between selections with the first selection being random. The interval can be based on a number (like every $30^{th}$ item in the list) or a monetary value (like ₹ 30000 of cumulative value of sales after the last selection). Though this method seems very easy, the auditor must ensure that the population is not structured in a manner that the interval always corresponds to any pattern in the population. For example, if in a population of branch transfer, a particular branch transfer occurs every $100^{th}$ time and sampling interval selected is 100 (or any other number of which 100 is a multiple), the auditor will either end up with selecting all that particular branch transfer or selecting none of them depending on the position of the random start. To avoid such a problem he may consider more than one starting point.

Systematic sampling can again be of two types:

***Block Sampling***

This method requires selection of a defined block of consecutive items. For example, the auditor may select first 100 entries of the purchase day book for the month of July or any two blocks of 50 purchase items from July. Thus, once the first item is selected the next 49 items of the block will normally follow it for selection. This method is simple and economical. But there is also possibility of bias.

***Cluster Sampling***

Under this method, the population is first divided into a number of groups known as clusters (for example, purchase and sales invoices are kept in months or wage records are kept in weeks). The auditor then selects a number of clusters randomly instead of selecting individual items of population. Selection of clusters can be made using random number tables. In the next stage, the items in the clusters can be checked either completely or a proportion of them may be examined. Cluster sampling saves time which may be utilised to consider larger samples to enhance the reliability of sample results. However, as a method, it is outperformed by random or stratified sampling which selects individual items directly from the population.

#### C. Monetary Unit Sampling

This method uses the monetary value of the transaction rather than the items as the basis for sample size determination and item selection. It is also known as value-based sampling or value-weighted sampling.

#### D. Multi-stage Sampling

This method is suitable when data are stored in more than one level. For example, an organisation may have stock stored at a number of shops. Here, the first step would be to randomly select a few shops and then to randomly select a few stock items from the shops already selected. If applied cautiously, this method proves to be very effective.

#### E. Haphazard Sampling

Under this method, the auditor selects items without following any predetermined or structured rule. However, the auditor must avoid any conscious bias or predictability while making such selection (such as selecting only odd numbered vouchers, entries in the first and last pages etc.,). Haphazard sampling is appropriate only for non-statistical or judgemental sampling.

### 4.1.6 Risk Associated with Audit Sampling

According to SA-500 on 'Audit Evidence' issued by ICAI, an auditor may use audit sampling in selecting items required to conduct an effective test to provide appropriate audit evidence to the extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. However, it cannot be denied that such a method will always involve some amount of risk. This risk associated with sampling can broadly be divided into two categories:

#### A. Sampling Risk

Since sample is only a selected part of the population, it can never reflect all the characteristics of the population. Accordingly, results obtained from sample units are bound to differ from that based on entire population, at least to some extent, irrespective of the sample size or the method applied for sample selection. This error is known as sampling error. Audit Sampling

is also subject to this error and the corresponding risk is known as sampling risk. According to SA-530, sampling risk may be classified into two broad categories:

***Sampling Risk Associated with Compliance Procedure***

Compliance procedure, also called test of control, is basically the process of evaluating the soundness of the internal control system of the organisation. While applying compliance procedure on internal control, the auditor faces two kinds of risk:

(i) The auditor may conclude that the controls are more effective while they are not. This may be called the risk of over reliance. This type of erroneous conclusion will lead to inappropriate audit report.

(ii) Alternatively, the auditor may conclude that the controls are less effective while they are not. This is the risk of under reliance. This type of erroneous conclusion will lead to additional audit work.

***Sampling Risk Associated with Substantive Procedure***

Substantive procedure, also known as the test of details, is defined as the process of evaluating the validity and appropriateness of the data generated through the system of recording transactions. This process aims to identify misstatements. While applying substantive procedure on transaction, the auditor again faces two kinds of risk:

(i) The auditor may conclude that there are no material misstatements, while they do exist. This is known as the risk of wrong acceptance. Wrong acceptance makes the audit report simply untrustworthy.

(ii) Alternatively, the auditor may conclude that there are material misstatements while they do not exist. This is called the risk of wrong rejection. This significantly increases the load of the audit work.

Unfortunately, both the risks under each category of procedures create hazards for the auditor and hence, should be avoided to ensure quality of audit work.

### B. Non-sampling Risk

While conducting sampling, error may also arise due to improper processing of data, lack of expertise to analysis, etc. These are called non-sampling error or bias. An auditor may reach inappropriate opinion due to these factors also. The resulting risk is defined as non-sampling risk.

Non-sampling risk is avoidable. If the sampling is done by experienced audit clerks and they remain alert while analysing the selected transaction, non-sampling risk can be reduced to minimum or even zero. On the other hand, sampling risk is unavoidable. The auditor can only reduce it to the possible extent by adhering to a proper method of sampling and by increasing the sample size reasonably.

### 4.1.7 Stages in Audit Sampling

Audit sampling requires the following steps:

**(i) Sample Design** At this stage the auditor should carefully consider the objectives of sampling and the nature of the population units. Based on this consideration, he must finalise the sampling method. For example, if population units are mostly homogeneous, simple random sampling may be adopted.

**(ii) Sample Size Determination** Sample size should be so determined as to minimise the sampling risk. Sample size can be determined by the application of a statistics based formula or by professional judgement of the auditor.

**(iii) Sample Selection** Sample units should be so selected that each sample becomes a representative of the population concerned and any bias is avoided.

**(iv) Performing Audit Procedures** The auditor, then, perform the audit procedure on each item selected. If the procedure is not applicable on a selected item, it should be performed on a replacement item. If the auditor is unable to apply the procedure at all, it will be considered as a deviation from the prescribed control (in case of test of control) or a misstatement in case of a test of details.

**(v) Nature and Cause of Misstatements** The auditor shall identify the nature and cause of misstatement to evaluate its possible impact on the purpose of auditing. The auditor must be least assured whether or not such misstatement is representative of the population.

**(vi) Projecting Misstatements** In case of test of details (i.e. vouching and verification), the auditor must project misstatements found in the sample to the population. However, for test of control (i.e. testing the effectiveness of internal control) no explicit projection is required.

**(vii) Evaluating the Results of Audit Sampling** Evaluation of the results may raise the following situations:

(a) In case of test of control, a high degree of sample deviation will lead to an increase in the assessed risk of material misstatements.

(b) In case of test of details, an unexpectedly high misstatement amount will mean that a class of transaction or account balance is materially misstated. In such a situation, if the projected misstatement is higher than the tolerable misstatement, the auditor will conclude that the sample does not provide a reasonable basis for the population tested.

(c) In the above case, the auditor will either

- Ask the management to investigate the misstatements identified and also any potential misstatement and to undertake necessary adjustments; or
- Modify the nature, timing and extent of those audit procedure to achieve better results. For example, the auditor may increase the sample size or test an alternative control.

## 4.2 AUDIT PROCEDURES

While conducting the audit of an organisation, an auditor resorts to various procedures. Some of these are invariably applied in all cases whereas some others are used only, if situation so demands. These are popularly known as Audit Procedures.

Selection of appropriate audit procedure depends solely on an auditor's skill, knowledge and professional experience. Some of the common procedures which have wide application are:

(i) Routine Checking
(ii) Test Checking
(iii) Auditing in depth
(iv) Cut-off Examination
(v) Surprise Checking
(vi) Rotational Tests; and
(vii) Walk Through Tests

These are discussed in the following sections:

### 4.2.1 Routine Checking

#### A. Concept and Definition

Routine checking may be defined as the procedure to check whether the transactions are properly entered in the books of accounts and whether the posting and carry forwards are done accurately. In other words, routine checking is done to ensure that mathematical accuracy is maintained while recording transactions in the books of accounts. This is quite helpful to detect errors and frauds of very simple nature.

#### B. Scope of Routine Checking

Routine checking comprises of the following functions:

(i) Examining the correctness of casting and balancing of the books of primary entry, i.e. special journals and journal proper.
(ii) Examining the correctness of posting from the books of primary entry to the ledger accounts.
(iii) Examining the correctness of casting, balancing and carry forwards of ledger accounts.
(iv) Examining the correctness of trial balance prepared based on the ledger account balances.
(v) Examination of correctness of final accounts i.e. Profit and Loss Account (or Income and Expenditure Account, in case of non-profit organisation) and Balance Sheet.

### C. Objectives of Routine Checking

The objectives of routine checking are:

(i) **Checking Arithmetical Accuracy** Routine checking ensures arithmetical accuracy of books of accounts by verifying the correctness of casting, posting, balancing and carry forwards.

(ii) **Preventing any Material Alteration in Accounts** Since routine checking is done by the audit clerks using distinctive tick marks, it becomes almost impossible to alter any figure of accounts already checked.

(iii) **Detecting Errors and Frauds of Simple Nature** Routine checking helps to detect unintentional errors and frauds of very simple nature and of small amounts.

(iv) **Improving the Reliability of Final Accounts** As effective routine checking minimises the possibility of errors, the reliability of annual accounts improves significantly.

(v) **Providing the Base for Subsequent Audit Work to Identify Serious Errors and Frauds** After an effective routine checking, conducting detail audit work to identify serious errors and frauds become much easier.

### D. Advantages of Routine Checking

(i) **Simple in Nature** Routine checking is probably the simplest form of audit work.

(ii) **No Special Knowledge Required** It does not require any special knowledge of complicated accounting theories or legal provisions. Hence, a general audit clerk with fundamental knowledge of accounting can perform this. Actually it provides the scope to introduce the new entrants to the profession.

(iii) **Ensuring Arithmetical Accuracy** Since routine checking effectively examines the correctness of casting, posting, balancing and carry forwards, arithmetical accuracy of the books of accounts is ensured.

(iv) **Detection of Errors and Frauds** Routine checking thoroughly examines the entries of the primary books of accounts and their posting to ledgers. As a result, simple errors and frauds are easily detected.

(v) **Ensuring Correctness and Fairness of Final Accounts** Since routine checking thoroughly examines the correctness and completeness of recording in the primary books of entry as well as ledger accounts accuracy and fairness of final accounts are ensured.

### E. Limitations of Routine Checking

Routine checking suffers from the following limitations:

(i) **Mechanised System Creating Monotony among Audit Clerks** The functions under routine checking are largely mechanised and similar in nature. This may develop a sense of monotony among the audit staff.

**(ii) Negligence on the Part of Audit Clerks** Under routine checking there is hardly any scope for applying any specialised skill. As a result, the audit staff may sometimes become negligent towards their duty especially in a case where internal control is effective.

**(iii) Not Possible to Detect all Types of Errors** Routine checking can only detect errors of omission, commission and misposting. It cannot identify compensating errors and errors of principle.

**(iv) Planned Frauds cannot be Detected** Routine checking fails to detect any fraudulent manipulation in the books of accounts.

### F. Auditor's Duty Regarding Routine Checking

Routine checking is an integral part of any audit work. A well-executed routine checking significantly reduces the subsequent workload of the auditor and also improves the quality of the audit work. As a result, the auditor must carefully decide the scope and depth of the intended routine checking. In this respect an auditor's duties will be as follows:

(i) If there exists an internal control system in the organisation, the auditor must judge the effectiveness of such system and its components, i.e. internal check and internal audit and should accordingly decide the scope and depth of routine checking.

(ii) In case of small and medium enterprises, where the number of transactions is limited, the auditor must put more stress on routine checking.

(iii) In case of large organisations, where the number of transactions is many, it may not be wise to apply through checking of books of accounts. The auditor, in that case, may resort to test checking. However this may appear to be risky at times. Hence, the auditor may try to strike a balance by applying routine checking in some selected areas.

(iv) Since routine checking is performed by audit clerks and not by the auditor himself, an auditor may sometimes conduct a surprise examination to see whether the checking is performed as per the instruction and whether the distinctive tick marks are used appropriately.

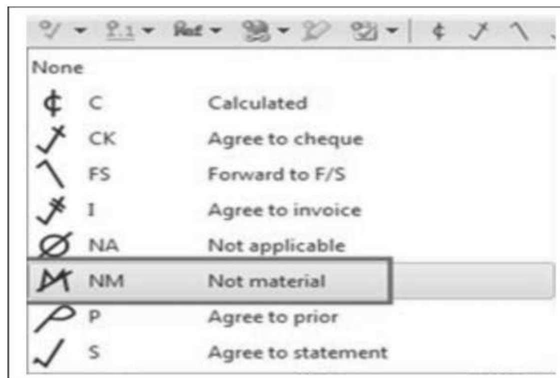


**Fig. 4.1** A few symbols used in routine checking

### 4.2.2 Test Checking

#### A. Concept and Definition

In large organisations with huge number of transactions recorded in the books of accounts, conducting a detail examination of all accounts becomes a mounting task for the auditor. Additionally, due to the prevalent periodic audit system, the auditor is required to submit his report within a definite time period. This further adds to his difficulty. However, in large organisations, where an effective internal control system is in place, such detail examination of all transactions is not only impracticable but also an unnecessary waste of resources. This is because sound internal control system ensures correctness of accounts to a great extent. Thus, in these circumstances, an auditor selects a few transactions out of a number of similar transactions and conduct in-depth examination of those. If no irregularities are found, then it is assumed that all the transactions have been recorded properly. This procedure is known as test checking.

According to Prof. Meigs, test checking is the selection and examination of a representative sample from a large number of similar items. Thus, to define formally, test checking refers to a procedure where instead of a detail examination of all transactions, a number of representative transactions are selected out of a group of similar transactions and in-depth examination is done to those.

#### B. Rationale behind Test Checking

The concept of test checking is based on the principle of 'Sampling Theory' in Statistics. According to this theory, a well representative sample will always reflect most of the characteristics of the aggregate, i.e. population (law of statistical regularity). Moreover, as the sample size increases, the deviations between the results based on sample and that of aggregate or population will get reduced (law of inertia of large numbers). To combine the both, a representative sample of sufficiently large in size will reflect almost all the characteristics of the population with minimum error. Thus, during the course of auditing of a large number of similar transactions, a test checking based on a well representative sample with adequate size will surely help the auditor to form an opinion about the entire group.

#### C. Precautions to be Taken before Initiating Test Checking

Organisations differ in their structure or set up. As a result, it is quite difficult to determine any common parameters while attempting test checking. Still an auditor needs to apply the following general precautions while conducting a test checking.

(i) The auditor should review the internal control system of the organisation. This will help him to decide the scope of test checking.

(ii) Transactions selected for test checking must cover different time periods of the year.

(iii) Transactions should be selected in such a way that they cover almost all the employees at least to some extent.

(iv) Transactions should be homogeneous in nature.
(v) So far practicable, random sampling method should be applied to select transactions out of a homogeneous group.
(vi) Sample size must be adequate.
(vii) Transactions during the first and the last month should be cautiously verified because these periods have relatively high chance of errors and frauds.
(viii) Selection bases should be consistently changed to avoid any speculations.
(ix) Control accounts and impersonal ledgers should not be test checked.
(x) Cash book and pass book or bank statements should be verified preferably on a single day. Moreover, it is better not to follow test checking in these cases.
(xi) Change in the method of accounting should be carefully handled. Sufficient transactions before and after such change should be verified to minimise any chance of fraud.
(xii) Selection of transactions should preferably be done by the auditor himself and should be kept secret.

### D. Objectives of Test Checking

The objectives of test checking are:

(i) To draw a valid conclusion on the correctness of accounts based on a limited number of transactions.
(ii) To save cost of conducting audit work.
(iii) To complete the audit work within a limited period of time.

### E. Advantages of Test Checking

The advantages of test checking are:

**(i) Time Saving** As test checking requires examination of a limited number of transactions, the audit work is completed in lesser period of time and report is submitted in due time.

**(ii) Cost Saving** Under test checking, audit work is done at a reduced cost.

**(iii) Reduction of Work Pressure of the Auditor** Since the auditor needs to examine only a selected number of transactions, it significantly reduces his work pressure.

**(iv) More Number of Audit Assignments** Reduction in work load helps the auditor to take up simultaneous assignments.

**(v) Keep Employees More Alert** Since under test checking any transaction can be selected for verification by the auditor, the employees of the organisation remain always under pressure and become more alert and careful in their duty.

### F. Limitations of Test Checking

The limitations of test checking are:

**(i) Effectiveness Depends on Internal Control System** The success of test checking largely depends on the effectiveness of Internal Control System. Thus, in an organisation

where there is no internal control system or where it is not implemented in a planned manner, a test checking will increase the audit risk further.

**(ii) Chance of Errors or Frauds to Remain Undetected** Since all transactions are not covered by test checking, there may be a chance of errors or frauds to remain undetected.

**(iii) Auditor's Risk and Responsibility Increases** Under test checking the auditor needs to form his opinion based on the examination of a few selected transactions. This significantly increases his risk and responsibility because if any irregularities are found afterwards, he may be held liable for professional negligence.

**(iv) Not Suitable for Small Organisations** This procedure is not suitable for small organisations as internal control system is normally not used here.

**(v) Chance of Non-disclosure of a Fair View of Accounts** Since some errors or frauds may still remain undetected, this procedure always has a chance of not exhibiting a true and fair view of the accounts maintained and results produced.

**(vi) Sampling Technique has to be Appropriate** The effectiveness of test checking largely depends on the method chosen for selecting the samples. Test checking is sure to fail in case the samples are not truly representative of the population.

### G. Transactions Where Test Checking is Inappropriate

Theoretically, test checking can be applied in any situation where the number of transactions is sufficiently large. However, there are a few transactions where test checking is not at all suitable. Usually, the following kinds of transactions are recommended to be kept outside the purview of test checking.

(i) In industries where activities are subject to seasonal fluctuations (e.g., umbrella, rainwear, etc.), test checking should not be applied on annual basis.

(ii) Transactions which have legal implications or are to be recorded following legal provisions (e.g., managerial remuneration, deferred tax assets or liabilities) must not be test checked.

(iii) Transactions which are either exceptional or non-recurring in nature should not come under test checking.

(iv) Transactions which are based on estimates (e.g., provision for doubtful debt or discount, depreciation, etc.) should be kept outside the purview of test checking.

(v) Opening entry, closing entry, adjustment entry, rectification entry and bank reconciliation statements should never be test checked.

(vi) Presentations and disclosures under financial statements should also not be subject to test checking.

### H. Auditor's Duty Regarding Test Checking

It is true that test checking instead of routine checking can significantly reduce the workload of an auditor, especially in case of a large organisation. However, such a process always entails

some amount of risk. If test checking is applied without sufficient precautions, then the auditor may be held liable for professional negligence in case any material misstatement is found afterwards. Thus, an auditor should determine the scope of test checking only after scrutinising the existing internal control and internal check system. In case these are found inadequate, he should never opt for test checking. Moreover, if any material misstatement is found during the course of test checking, he should be more alert and should preferably drop the idea of test checking right away. Further, he should avoid test checking of some special transactions like bad debt, depreciation, closing entries and adjustment entries. Additionally, while forming the representative sample, he should preferably apply simple random sampling as much as practicable. Last but not the least, he must remember that it is not possible that all transactions will be test checked. He must verify some transactions on a detail basis.

### 4.2.3 Auditing in Depth

#### A. Concept and Definition

Auditing in depth refers to the procedure where a few selected transactions are meticulously examined from their beginning to their conclusion. In other words, it is a system which reviews each and every single aspect of a transaction during its execution as well as recording.

It is particularly helpful in case of large organisations where detailed examination of all records at every stage of a transaction is almost impossible. Hence, through this system, the auditor selects a few representative transactions of material importance from a particular category and then conducts a detailed stage by stage examination. If no irregularity is found, the auditor may come to a conclusion that the entire category of transactions is likely to be free from any material irregularity.

#### B. Relation between Routine Checking, Test Checking and Audit in Depth

Though routine checking and test checking are the two most widely used procedure of auditing, both have some shortcomings. Routine checking requires detail examination of every transaction which is extensive, time consuming and a costly affair. On the other hand, test checking requires examination of a few independently selected transactions which entails significant risk, if not properly executed. Audit in depth has basically emerged to eliminate the limitations of both the methods. Thus, it is an intermediate approach.

#### C. Process of Audit in Depth

Audit in depth is a three-step process where (a) the auditor first reviews the effectiveness of the internal control system, (b) then selects a few transactions of material importance from each category and (c) finally conducts examination of each and every stage of the execution and recording of the selected transactions based on sufficient documentary evidence. For example, audit in depth in case of a purchase transaction will require the following steps:

(i) Examination of stores requisition note to ensure that it has been duly authorised.

(ii) Examination of the purchase order issued by the purchase department to ensure that the order was executed on the official form following every predefined rule in this respect and was issued by designated official.

(iii) Examination of the delivery note from the supplier to see, if there is any deviation from the purchase order.

(iv) Examination of the goods received note to ensure that it has been properly authorised and the quantity and description has been duly checked.

(v) Verification of the entries in the store record.

(vi) Verification from the accounts section that the purchase invoice has been duly matched with the copy of the purchase order and copy of the goods received note before processing the bill.

(vii) Verification of the entries made in the books of accounts.

Thus, in case of audit in depth, the auditor would not merely satisfy himself that a transaction has been properly recorded in the accounts but would also verify operational appropriateness at every single step of its execution.

### D. Applicability of Audit in Depth

It is very difficult to suggest specific areas or instances where audit in depth should be applied. Rather, it depends upon the situation. Since success of audit in depth largely depends on an effective internal control system, any large organisation with adequate internal control mechanism is suitable for audit in depth. The auditor, therefore, first needs to evaluate the existing internal control system of the organisation. If on evaluation it is found that the internal control system is not functioning efficiently, he should also avoid audit in depth and rely upon routine checking. Similarly, in case of small organisations, with relatively less number of transactions and without any internal control system in built, this method is also not desirable at all.

### E. Advantages of Audit in Depth

The advantages of audit in depth are:

**(i) Precise** Audit in depth helps to achieve precision in course of audit work.

**(ii) Saves Time** Examination of a few selected transactions significantly reduces the time required to complete the audit work.

**(iii) Less Expensive** Cost of audit can be reduced significantly.

**(iv) Not Monotonous** Since the auditor always needs to deal with new ideas and techniques while verifying the operational and recording aspects of selected transactions, it offers diversity in the audit work and audit clerks do not feel monotony.

**(v) Keep Employees More Alert** Since any transaction can be selected for verification by the auditor, the employees of the organisation remain always under pressure and become more alert and careful in their duty.

(vi) **Accuracy of the Overall Opinion** Since important transactions are only examined, there is lesser chance of the overall audit report being wrong.

(vii) **Helps in Propriety Audit** This technique is considered to be very effective in propriety audit.

(viii) **Innovative Thoughts** The analytical aspect of audit in depth provides the auditor more food for thoughts. They may use the experience in preparing future audit plans.

### F. Limitations of Audit in Depth

The limitations of audit in depth are:

(i) **Limited Applications** This procedure is not applicable for small concerns and organisations not having any effective internal control system.

(ii) **Risk** Since only some selected transactions are examined in detail, this procedure involves risk of non-detection of some errors or frauds.

(iii) **Depends on Proper Selection of Sample** The success of audit in depth depends on appropriate sample selection. Improper handling by the auditor will only entail loss of time and cost.

(iv) **Non-disclosure of Fair View** Since some of the errors or frauds may escape the sampling process, financial statements may not exhibit a true and fair view.

(v) **Fraud in Less Important Transactions** Since transactions of material importance are selected in this process, frauds may be committed in less important transactions. However, the cumulative effect of such small frauds may cost a lot to the firm.

## 4.2.4 Cut-off Examination

### A. Concept and Definition

In case of a terminable venture which is formed for a limited period of time, transactions are settled within its lifetime and profits are calculated only once. But in case of a going concern, business operations and hence, transactions occur on a continuous basis. Thus, it is imperative to apply the periodic concept to assess its performance and financial state at regular intervals. However, there may be a number of items especially at the end of an accounting period that may have their impact carried to the next accounting period. Work in progress, goods in transit, goods sent on approval basis lying with the customers, outstanding and prepaid items are only a few. Even purchase and sale transactions during the end of the accounting period may have their impact on the next year. Improper treatment of these items and inclusion of items relating to one year in the next or previous year (like purchase and sales) may seriously distort the financial results and mislead the decision makers. Hence, an auditor, during the course of his audit work, should apply definite procedure to separate transactions at the end of one accounting period from those at the commencement of the next accounting period. Such a procedure is known as Cut-off Examination or Cut-off Procedure. Here, the auditor

first decides a cut-off date (in case of annual audit, generally balance sheet date is considered to be the cut-off date) and then examines all the transactions that occurred within a definite time period prior and post such cut-off (known as cut-off period) date to discriminate transactions of current year from that of the next year. This is essential to eliminate any scope of manipulation in accounts.

### B. Objectives of Cut-off Examination

The objectives of cut-off examination are:

(i) To separate the transactions of current accounting period from that of the next period.
(ii) To effectively apply the principle of matching revenues with costs incurred to generate such revenues.
(iii) To ensure that the doctrine of consistency has been maintained in presenting various information and in valuing the assets and liabilities.
(iv) To ensure that adjustment entries have been duly entered.
(v) To detect and prevent any error and fraud in relation to the year-end items.
(vi) To ensure disclosure of a true and fair view in final accounts.

### C. Auditor's Duty Regarding Cut-off Procedure

In order to form a conclusive opinion on the fairness of financial statements, an auditor needs to justify the methods applied in cut-off. Thus, the auditor has specific duties regarding various transactions during the cut-off period. These are discussed below:

**(i) Purchase Transactions** The auditor should satisfy himself that purchase includes only those goods whose ownership has already been transferred and must also see that the same has been recorded in the stores while calculating the closing stock. In case of credit purchase, the auditor must also verify that supplier's account has been duly credited.

**(ii) Sales Transactions** The auditor must satisfy himself that sales includes only those goods whose ownership has already been transferred and must also see that the same has been deducted from stores while calculating the closing stock. In case of credit sales, the auditor must also verify that customer's account has been duly debited.

**(iii) Undelivered Goods** The auditor should also see that any undelivered goods for which sales invoice has already been prepared is deducted from the stores and included in the sales figure.

**(iv) Goods-in-Transit** The auditor should see that any goods purchased during the year end for which purchase invoice has been received but the goods are yet to reach the stores, are included in the accounts as Goods-in-transit.

**(v) Goods on Approval** The auditor must satisfy himself that any goods, sent to the potential customers on approval basis, on which no confirmation is received and time to approve has not yet expired, are included in stock. He must also see that the sale value of such goods is not included in total sales or debtors.

**(vi) Work-in-Progress** The auditor must see that current year's work-in-progress has been properly valued and included in the value of closing stock.

**(vii) Pre-received Income, Prepaid and Outstanding Expenses** The auditor must see that income and expenses relating to a particular year are included in the accounts of that year only. For this he has to carefully verify the adjustment of any item of pre-received income and prepaid or outstanding expenses in the final accounts.

### 4.2.5 Surprise Checking

#### A. Concept and Definition

Under traditional audit practices, an auditor generally informs the client about his routine checking plan and timing of next visit well in advance. This is considered essential so that the client's staff can keep the books of accounts complete in all respects and readily available for verification. Unfortunately, this also provides them ample scope for concealing any wrong-doings whatsoever. Thus it is generally recommended that an auditor must also conduct surprise tests of some material items without any prior communication with the client's office. These surprise checks, as a part of the normal audit procedure, are likely to increase the efficiency of the audit work. Hence, surprise checking may be defined as an audit procedure where verification of some material items is conducted on a non-routine and surprise basis.

#### B. Application Areas of Surprise Checking

Though surprise checking can be applied while verifying transactions of any category, following are some specific instances where this procedure is particularly helpful.

(i) Verification of cash balance.
(ii) Verification of investments.
(iii) Verification of stock and stores.
(iv) Verification of the effectiveness of any part of the internal control system.
(v) Verification of appropriate maintenance of various statutory books of accounts, registers, etc.

#### C. Recommendations of ICAI Regarding Surprise Checking

Surprise checking is conducted by an auditor only occasionally. Following are the recommendations of ICAI in this respect:

(i) The scope of surprise checking should be decided by the auditor himself.
(ii) Surprise checking may be conducted more than once. However, this should be decided by the auditor considering the actual situation. Generally, it is conducted at least once during every audit.
(iii) If any errors or frauds are detected through surprise checking, the auditor must immediately inform the same to the management.

(iv) Any inadequacy of internal control system found in the course of surprise checking must also be informed to the management on an immediate basis.

(v) The auditor must satisfy himself that proper corrective measures have been initiated by the competent authority against the areas reported to the management.

(vi) The result of surprise checking should not be mentioned in the final audit report unless there is any material misstatement or misappropriation found by surprise checking that can seriously distort the true and fair view of final accounts.

### 4.2.6 Rotational Tests

This is another important audit procedure that is very useful while conducting audit of large organisations with operations located at different geographical locations. Rotational tests can be performed in two ways:

**(i) By Rotating the Area of Emphasis** Here, the auditor conducts general system audit of all areas of the client's business every year but selects one or two specific areas (like payroll, stock control, sales, etc.) for in-depth checking.

**(ii) By Visiting Different Locations on a Rotational Basis** Here, the auditor visits different factories, branches, etc on rotation, so that all the locations are covered though not within a single year but over a period of time.

It must be mentioned clearly in this respect that rotational tests are only applicable in case the same auditor is engaged for audit over the years. Moreover, the selection of areas must also be made on a random basis without allowing the client's staff to speculate anything.

### 4.2.7 Walk Through Tests

#### A. Concept and Definition

In course of the audit work, an auditor depends significantly on the effectiveness of the internal control system and finalises the scope of auditing. However, to form a conclusive opinion regarding the effectiveness of the accounting system and associated internal control procedure, he needs to have adequate understanding of the control environment. Walk through tests may come handy in this respect.

Walk through test may be defined as tracing one or more transactions through the accounting system and observing how it is actually passed through the internal control system. For example, the auditor may decide to trace a purchase transaction from its initiation to its completion and recording. This will require him to see how are requisitions generated, orders placed with the suppliers, goods received and taken to the stores, bills processed and finally the accounting treatment done. If the auditor is satisfied about the appropriateness of all the relevant stages of the transaction, he may conclude that the internal control is functioning well. Accordingly, the auditor may decide to put reliance on the system to a certain extent and plan his audit work to verify some selective transactions only. Alternatively, if walk through test reveals serious weakness of the internal control system, the auditor may opt for verifying

a larger sample under test checking or at the worst situation, be may go for routine checking of all transactions.

### 4.2.8 Conclusion

It is worthy to mention in this respect that the different audit procedures described earlier are not always substitute to each other, rather in most of the cases, they appear to be complementary. Though it is up to the auditor to finally decide which procedure will be followed, simultaneous application of a number of procedures to verify different areas of client's accounts is always recommended.

## 4.3 ANALYTICAL PROCEDURE

Traditional audit procedures such as routine checking or test checking based on carefully selected representative samples help an auditor to identify the existence of material misstatements or misappropriation to a great extent. However, the books of accounts may sometimes contain complex errors or planned frauds that are difficult to identify by these traditional methods. Existence of such errors or frauds may be quite fatal as that will eventually make the audit report unreliable. Hence, the auditor should apply some innovative procedures to deal with a situation of that kind. Analytical procedure has become very effective in this respect.

### 4.3.1 Definition

Analytical procedure may be defined as the process to carefully study the relationship between various financial and non-financial data, analysing their behaviour or pattern to identify any unusual deviation from the expected value of the item or any inconsistency with the relevant information and the reason thereof. According to SA520 on 'Analytical procedures', analytical procedure means evaluation of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompasses such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

### 4.3.2 Nature of Analytical Procedures

As per SA520, the nature of analytical procedures includes the following:

(i) Analytical procedures consider comparison of entity's financial information with

   (a) Comparable information of prior periods.
   (b) Any anticipated results of the organisation like budget or forecast or any estimation by the auditor like estimation of depreciation.
   (c) Similar information of any other comparable entity belonging to the same industry or the industry averages.

(ii) Analytical procedures may also include consideration of relationships:
   (a) Among different items of financial data that is expected to follow a predictable pattern like the operating profit margin.
   (b) Between financial and non-financial information like the number of employees and the total compensation cost.

(iii) Analytical procedures consider application of diverse analytical tools that may range from a simple comparison to complex analysis involving advanced statistical techniques.

(iv) Analytical procedures may be applied either on standalone or on consolidated financial statements. Moreover they can be applied on any component or individual information of the statements.

### 4.3.3 Application of Analytical Procedures

According to SA520, analytical procedures can be applied at different stages of the audit work. These include:

#### A. Audit Planning

During the planning stage, the auditor may apply analytical procedures to have an understanding of the nature of client's business. This may help the auditor to identify the areas of potential risk by indicating different aspects and developments of which the auditor is still unaware. The auditor may use this information in determining the nature, timing and extent of other procedures such as routine checking or vouching.

#### B. Substantive Test

In order to reduce the audit risk by relying on substantive procedures, the auditor may apply substantive analytical procedures either alone or in combination with the test of details (i.e. vouching and verification).

#### C. Forming Overall Conclusion

The auditor may also apply the results of analytical procedures to assess how far the conclusions drawn based on individual components or elements of the financial statements are consistent and whether there is any need to revise them.

#### D. Investigating Unusual Items

If the analytical procedures performed in the organisation identify any inconsistency in relationships or any significant deviation from the respective expected value of the items, the auditor should investigate such items by inquiring the management or by collecting further evidences and by performing other audit procedures as required.

### 4.3.4 Tools and Techniques of Analytical Procedures

As per SA-520, analytical procedures include application of the following tools and techniques:

### A. Trend Analysis

This method analyses any fluctuation in the amount of any account or item by comparing current year's figure with that of either immediately preceding year or over the years.

### B. Testing of Reasonableness

This is done by analysing the relationship of certain items or account balances with other accounts or balances. Some examples of reasonableness testing are:

(i) Raw material consumption to production (quantity)
(ii) Percentage of wastage and scrap against production and raw material consumption
(iii) Work-in-progress based on material issued
(iv) Sales discount and commission against sales volume
(v) Rental revenues based on occupancy of premises
(vi) Interest expenses against interest bearing obligations

### C. Ratio Analysis

This technique calculates different ratios between various items of financial statements in order to study their relationships. Common ratios include:

(i) Elements of income or gain as a percentage of turnover
(ii) Gross Profit Ratio
(iii) Receivable Turnover Ratio
(iv) Inventory Turnover Ratio
(v) Any other profitability, leverage and liquidity ratio.

### D. Sources of Information

Analytical procedures also require analysing the following sources of information.

(i) Interim financial information
(ii) Budgets
(iii) Management Accounts
(iv) Non-financial information
(v) Bank and cash records including confirmation from bank
(vi) VAT returns
(vii) Board minutes
(viii) Confirmation from customers and suppliers.

## 4.3.5 Extent of Reliance on Analytical Procedures

Analytical procedures assume that there exist specific relationships among data (financial or non-financial) and hence, studying these relationships can help to locate any inconsistency in the books of account. However, the reliability of the results of analytical procedures largely

depends upon different aspects of the data itself. As per SA-520, reliability of analytical procedures depends on the following factors associated with the data.

**(i) Source of Information Available** The results of analytical procedures are likely to be more reliable when it is based on information obtained from independent sources outside the entity such as customers, banks, suppliers, etc.

**(ii) Comparability of the Information Available** Analytical procedures will be more reliable when data of the client is compared against the data of the industry or of comparable entities.

**(iii) Nature and Relevance of the Information Available** For meaningful results, analytical procedures should be based on standards that are rational. For example, financial data should be compared against budgets that have been established as results are to be expected rather than goals to be achieved.

**(iv) Control Over Preparation of Information** Information is likely to be complete, accurate and valid when there is effective control over the preparation of such information. In such a case, the results of analytical procedures are also likely to be highly reliable.

**(v) Regularity and Predictability of the Information** Recurring or regular items are mostly predictable and likely to have definite relationship with other regular items. Thus, analytical procedures based on this kind of information are more reliable. For example, the auditor may have better and consistent results while comparing any operating item over the years rather than an item of non-trading income.

**(vi) Materiality of the Information** Since material items need to be more carefully handled, analytical procedures should not be trusted alone but should be supplemented by test of details (i.e., vouching and verification).

### 4.3.6 Use of Analytical Procedures for Substantive Testing

Substantive testing or substantive procedure may be defined as the audit procedure that is designed to identify material misstatement at the assertion level by testing the authenticity and appropriateness of the information generated by the accounting system. This can be done either by substantive analytical procedure or by test of details or both. Here test of details mean test of transactions i.e. vouching and test of balances i.e. verification.

As per SA-330 on 'The Auditor's Responses to Assessed Risk', while designing and performing substantive analytical procedure either alone or in combination with the test of details, an auditor needs to consider the following factors very carefully.

#### A. Suitability of the Procedure

The auditor needs to determine the suitability of particular substantive analytical procedure for given assertions. He must take into account the assessed risk of material misstatement and the outcomes of test of details conducted for these assertions.

### B. Reliability of the Data

The auditor needs to evaluate the reliability of the data based on which his expectation of the recorded amount and ratios are developed. He must take into account the source, comparability, nature and relevance of information available and control over their preparation.

### C. Development of Expectation

The auditor needs to develop an expectation of the recorded amount and ratios and must evaluate the expectation is precise to detect any misstatement. In this process the auditor must consider the following:

(i) The accuracy with which the expected outcome of the substantive analytical procedure can be predicted. For example, the auditor may expect better and consistent results while comparing gross profit margin over the years rather than a discretionary expenses like research or advertising.

(ii) The degree to which the information can be disaggregated. For example, the substantive analytical procedure may be more effective when applied to financial information of individual entities rather than on consolidated financial information.

(iii) The availability of the information. For example, if financial information such as budgets or forecasts as well as non-financial information such as number of units produced or sold is available, then analytical procedure may be more effective.

### D. Materiality of the Deviation

The auditor needs to determine whether the difference of recoded amount from expected value is significant enough to undertake further investigation.

## SUMMARY

- Audit sampling is the process of selecting a limited number of transactions out of the total transactions of a given category (known as population) using a reasonable basis and applying the audit procedures on the selected transactions to form an opinion about the entire category.
- There are two approaches of sampling—Judgemental Sampling and Statistical Sampling.
- Some of the widely used sample selection methods are—random sampling including simple random sampling and stratified sampling, systematic sampling including lock sampling and cluster sampling, monetary unit sampling, multi-stage sampling and haphazard sampling.
- Risk associated with audit can broadly be classified into two types—sampling risk and non-sampling risk.
- Sampling risk can be associated with substantive procedure or compliance procedure.

- Selection of sample is done through a number of stages such as—sample design, size determination, sample selection, applying audit procedure, identifying nature of misstatements, estimate misstatements, evaluation of results.
- Routing checking is defined as the procedure to check whether the transactions are properly entered in the books of accounts and whether the posting and carry forwards are done accurately.
- Test checking refers to a procedure where instead of a detail examination of all transactions, a number of representative transactions are selected out of a group of similar transactions and in depth examination is done to those.
- Auditing in depth refers to the procedure where a few selected transactions are meticulously examined from their beginning to their conclusion. In other words, it is a system which reviews each and every single aspect of a transaction during its execution as well as recording.
- Inclusion of items relating to one year in the next or previous year (like purchase and sales) may seriously distort the financial results and mislead the decision makers. Hence an auditor, during the course of his audit work, applies definite procedure to separate transactions at the end of one accounting period from those at the commencement of the next accounting period. Such a procedure is known as Cut-off Examination or Cut-off Procedure.
- Surprise checks, as a part of the normal audit procedure, increase the efficiency of the audit work by verifying some material items on a non-routine and surprise basis.
- Rotational tests can be performed in two ways—by rotating the area of emphasis or by visiting different locations on a rotational basis.
- Analytical procedure is defined as the process to carefully study the relationship between various financial and non-financial data, analysing their behaviour or pattern to identify any unusual deviation from the expected value of the item or any inconsistency with the relevant information and the reason thereof.
- Analytical procedures can be applied at different stages of the audit work such as audit planning, substantive test, forming overall conclusion and investigating unusual items.

## EXERCISE

### A. Short Answer Type Questions (2–4 marks)

1. What do you mean by 'Audit Sampling'?
2. Discuss the needs or importance for audit sampling.
3. What do you mean by sampling risk?
4. What is random sampling?
5. What is stratified sampling?
6. What is haphazard sampling?

7. Do you think, audit sampling helps auditor in decision making? Is the use of audit sampling accepted? Explain the term stratified sampling. [*C.U. B.Com(H), 2014*]
8. What do you mean by substantive test in the context of audit sampling? [*C.U. B.Com(H), 2015*]
9. What do you mean by Routine Checking?
10. What is Test Checking?
11. What is meant by Audit in Depth?
12. What is Cut-off Procedure?
13. What is Surprise Checking?
14. What do you mean by analytical procedure in auditing? [*C.U. B.Com(H), 2013*]

## B. Medium Answer Type Questions (4–6 marks)

1. Briefly discuss four methods of sample selection methods under audit sampling. [*C.U. B.Com(H), 2015*]
2. Discuss the tools and techniques of applying substantive procedure. [*C.U. B.Com(H), 2015*]
3. Discuss the duty of an auditor in the context of test checking.
4. Discuss the scope and objectives of routine checking.
5. Discuss the duty of an auditor in the context of routine checking.
6. Discuss the advantages and disadvantages of audit in depth.
7. 'Test checking is based on a presumption' —What is the presumption? [*C.U. B.Com(H), 2000*]
8. What are the precautions to be taken before conducting test checking?
9. Briefly mention the transactions for which test checking is inappropriate.
10. Briefly discuss the process of audit in depth in case of purchase transactions.
11. Discuss the recommendation of ICAI regarding surprise checking.

## C. Essay Type Questions (8–10 marks)

1. Discuss the stages involved in audit sampling. [*C.U. B.Com(H), 2014*]
2. Explain sampling risk involved in:
   (i) Compliance Procedure
   (ii) Substantive Procedure [*C.U. B.Com(H), 2014*]
3. What is routine checking? Discuss the advantages and disadvantages of routine checking.
4. What is routine checking? Discuss the advantages and disadvantages of test checking.
5. What is audit in depth? Discuss the duty of an auditor in the context of audit in depth.
6. What is analytical procedure? Discuss its nature.
7. What are the areas where analytical procedure can be applied? Discuss the factors to be considered by the auditor while relying on the analytical procedures.
8. What are the factors to be considered in analytical procedure for substantive testing?

# 5 CHAPTER

# VOUCHING

## CHAPTER OUTLINE

**5.1** Meaning of Vouching
**5.2** Definition of Vouching
**5.3** Features of Vouching
**5.4** Objectives of Vouching
**5.5** Importance of Vouching
**5.6** Principles or Techniques of Vouching
**5.7** Vouching and Routine Checking
**5.8** Concept of Voucher
**5.9** Features of Valid Vouchers
**5.10** Types of Voucher
**5.11** Duties of an Auditor for Missing Vouchers
**5.12** Vouching of Different Items (Receipts and Payments Related)

## 5.1 MEANING OF VOUCHING

The dictionary meaning of vouching is 'confirming the truth or accuracy of a result of one's own experience.' It also means the 'act of supporting or guaranting or attesting'. On the other hand, voucher means 'any documentary evidence in support of any transaction'. So, the meaning of vouching and voucher reveals that these terms bear the essential quality of 'witness'.

At the end of any audit work, the auditor has to certify the accuracy, reliability and correctness of the books of accounts. While doing this, the auditor has to certify personally the authenticity and correctness of the documents which justify the transactions of the concern. These documents may be invoices, statements, receipts, correspondence, minutes, contracts, etc. These documents are termed as voucher and the processing of verifying the vouchers are called vouching. Vouching is the acid test of audit. It tests the truth of the transaction recorded in the books of accounts. It essentially consists of verifying the record of transactions contained in the books of accounts with the relevant documentary evidence and the authority

on the basis of which the entries were made. It also verifies whether the amount mentioned in the voucher has been posted to an appropriate account or not.

To summarise, the basis of reporting the financial statement as 'true and fair' mostly depends upon the procedure and approach of vouching. This is why vouching is often termed as the *'essence of auditing'* or *'backbone of auditing'*.

## 5.2 DEFINITION OF VOUCHING

The following definition of vouching are noteworthy.

According to J. Lancaster, "Vouching is a device used to prove that various transactions for the period are fairly, truly and sincerely reflected in the books of accounts".

In the words of Ronald A. Irish, "Vouching is a technical term, which refers to the inspection of documentary evidence supporting and substantiating a transaction".

According to Taylor and Perry, "Vouching is the examination of the evidence offered in substantiation of entries in the books, including in such examination the proof so far as possible, that no entries have been omitted from the books".

De Paula writes, "Vouching means the inspection of receipts with the transactions of a business together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorised and are correctly recorded in the books."

Prof. B K Basu defined vouching as an act performed by the auditor to authenticate the entries that are recorded in the books of accounts by substantiating the property of their source, i.e., vouchers.

Thus, in simple words, vouching means examination of accuracy, authority and authenticity of transactions that appear in the books of original entry with the help of vouchers of these transactions.

## 5.3 FEATURES OF VOUCHING

The following features of vouchers may be summarised from the above discussions:

(i) Vouching is an examination of entries in books of accounts.
(ii) The examination is done with the help of vouchers like receipts, invoices, counterfoil or cheque books & pay-in-slips, pass-book, agreements, resolutions, minute book, correspondence, etc.
(iii) It substantiates a transaction.
(iv) It ensures the correctness of transactions entered in the books.
(v) It is an important aspect of auditing.
(vi) Auditor begins his audit-work with vouching.

## 5.4 OBJECTIVES OF VOUCHING

The main objective of vouching is to find out the accuracy and authenticity of the entries appeared in the books of accounts. The success of an audit work largely depends on the efficiency with which vouching has been conducted. Some of the major objectives of vouching are summarised below:

(i) To ensure that all the transactions are properly recorded in the books of accounts.
(ii) To examine that entries recorded in the books of accounts are supported by documentary evidence.
(iii) To make it sure that fraudulent transactions are not recorded in the books of accounts.
(iv) To ensure that all transactions are properly authenticated by a responsible person.
(v) To ascertain that all transactions are duly authorised.
(vi) To confirm that the necessary vouchers relating to entries recorded in books are with the client. (Thus, the purpose of vouching is not merely to verify that the payments have been made, but to verify further that the payment relates to the business and is approved by the proper authority.)
(vii) To verify that no error has been committed while recording the transactions.
(viii) To ensure that the distinction has been made between capital and revenue items while recording the transactions.
(ix) To ensure the reliability of the figures presented in the books of accounts.
(x) To ensure the accuracy in totalling, carrying forward and recording of an amount in the accounts.

## 5.5 IMPORTANCE OF VOUCHING

Vouching is the act of checking evidential documents to find out errors and frauds and to know the authenticity, accuracy and reliability of books of accounts. It protects the business against the falsification and manipulation of accounts. The auditor commences his work with the examination of entries and vouching plays an important role in this respect. The correctness of books of accounts is tested by vouching. If the vouching is carried out with due care and intelligence, the audit work becomes smooth and easier. All subsequent steps of auditing are dependent on vouching.

In the words of De Paula, "Vouching is the essence of auditing." The success or failure of Auditing depends on vouching. Audit work is impossible without vouching. It is, therefore, no exaggeration to say that *"the vouching is the soul of auditing."*

The importance of vouching is given below:

**(i) Detection of Errors at Initial Stage** By checking the entries, with original evidence, the errors can be located at an early stage. The maxim that 'prevention is better than cure' is achieved as the vouching prevents the errors before they assume serious proportion.

**(ii) Detection of Frauds** An auditor checks the books of accounts to detect errors and frauds. Frauds may be committed by presenting duplicate vouchers. All the frauds, however small, can be detected with the help of vouching. So, all the evidential documents and records are to be checked carefully and in detail by an auditor which is the scope of vouching. With the help of vouching, even the planned fraud can be detected.

**(iii) Keeps the Auditor Alert** Since the starting point of audit is vouching, the auditor can detect errors and frauds in the beginning of audit. If he finds any errors, he becomes more alert and careful and extends his checking to every important transactions. He resorts to auditing in depth and can thus carry out his work in a more responsible manner. In case of *Armitage* vs *Brewer and Knott, 1982,* it was held that audit is dependent on vouching and if the auditor shows carelessness in vouching, he will be held liable for it.

**(iv) Reliable Examination** In vouching, the entries in original books of accounts are verified to ensure that the transactions are genuine. These entries are authenticated and complied with normally accepted principles of accounting. If a transaction is not authenticated or is not properly recorded, then the final accounts would not show a true and fair view of the profit or loss and state of affairs of the business. The entries in the books of original entries are the foundation on which the correctness of entire accounting record is based. Thus, vouching tests the very base of accounting process.

**(v) Ensure Correctness of the Books of Accounts** Checking of entries is done by examining the original evidence supporting such entries. Vouchers are thus links between transactions and entries. By vouching, the particulars of transactions, such as dates, amounts, the names of parties, etc., are known. Thus, the details are compared with the final evidence establishing the correctness of entries in books of accounts.

**(vi) Essence of Auditing** Auditing not only checks the accuracy of books of accounts but also checks whether the transactions are related to the business or not, all the transactions are performed after the prior approval of the concerned authority or not, transactions are real or not, because an accountant may include fictitious transactions to commit frauds. All these facts can be found with the help of vouching.

**(vii) Find Out the Unrecorded Transactions** Since each and every transaction is checked and ratified on the basis of document, vouching helps to find out the unrecorded or missing transactions. If any voucher is found unrecorded, the auditor can suggest to record such transactions.

**(viii) Authorisation of Transactions** If the transactions are made on the consent of concerned authority, such transactions are known as authorised transactions. If transactions are not authorised, such transactions can be fictitious transactions. Fictitious transactions can be found with the help of vouching.

Therefore, it can be said that vouching is the heart of auditing because without the work of vouching, the work of auditing cannot be performed. The main aim of auditing is to detect errors and frauds for proving the truth and fairness of results presented by the income statement and the balance sheet. Vouching is the only way of detecting all sorts of errors and planned frauds. So, it is the backbone of auditing.

## 5.6 PRINCIPLES OR TECHNIQUES OF VOUCHING

At the time of vouching, the auditor should keep in mind the following important principles

**(i) Arrangement of Vouchers** The auditor should see that the vouchers are consecutively numbered according to the date and the order of transactions. In addition they should be properly filed. If this is not done, then the auditor's time would be unnecessarily wasted in finding out the required vouchers.

**(ii) Checking of Date** The auditor should carefully check the dates on vouchers. The vouchers should relate only to the year for which the accounts are audited. Otherwise the vouchers of earlier years may be produced again and cash or goods might be misappropriated.

**(iii) Name in the Voucher** The vouchers should be in the name of the client. The transactions recorded in the books of a client would be correct, only if they are supported by bills, documents and other evidences in the name of that particular client. The name of the party from whom the voucher is received should be compared with the name of the supplier in the books of accounts.

**(iv) Compare the Words and Figures of the Amount** The amount in voucher should be indicated both in figures and in words, so that the alterations in figures can be avoided. He should examine whether the figures and words are same or not in the voucher. The amount shown in the voucher should also tally with the amount recorded in the books of accounts.

**(v) Checking of Authority** The auditor should examine that all the vouchers are passed by the authorised officer. The person who authorises payment or other transaction should put his signature in support of having approved the voucher. The auditor should have with him the specimen signature of various officers, with schedule of their powers.

**(vi) Cancelling the Voucher** Once the voucher is audited, the same should be cancelled so that it may not be produced again. Rubber stamp, seal or ticks of particular colour is used to cancel the voucher.

**(vii) Strikingout or Change of Figures** If there is any strikingout or change of the figures on the receipts and vouchers, it should be signed by the authorised officer. The auditor should satisfy himself by inquiring about it.

(viii) **Transaction Must Relate to Business** The auditor should carefully examine that the entries must relate to the business. The auditor should not accept the voucher in personal name.

(ix) **Revenue Stamp** The auditor should also check whether the voucher bears a required revenue stamp or not.

(x) **Cancelled Voucher** The auditor should not accept the cancelled voucher as it has already served the purpose of payment.

(xi) **Agreements** These provide the basic information to the auditor. He should check the agreements, correspondences and other relevant papers.

(xii) **List of Missing Vouchers** After vouching is over, the auditor should go through the relevant books or register and find out the un-ticked items. The items may not be ticked for want of vouchers. The auditor should prepare a list of missing vouchers and ask the person concerned to obtain the same.

(xiii) **Entry in the Books of Accounts** While examining vouchers, the auditor should see that the correct entry is passed in the books of accounts and he should also see that no voucher is left for being recorded in the books of accounts. Moreover, as per details of voucher, correct classification of revenue and capital is done.

(xiv) **Continuous Vouching** As far as possible the auditor should complete the vouching of a particular period of a book in single sitting. If the vouching is kept pending or incomplete, then there are chances of figures being altered and a fraud being committed after the vouching is over.

## 5.7 VOUCHING AND ROUTINE CHECKING

Routine checking means checking the arithmetical accuracy of books of original entry and ledgers with a view to detect clerical errors and frauds of very simple nature. These include:

(i) Checking casts, sub casts, carry forwards, extensions and other calculations in the books of original entry.
(ii) Checking transfer of transactions from original books of accounts to the ledger account.
(iii) Checking debit and credit side of various accounts.
(iv) Checking transfer of balances of various accounts to other pages or accounts or statements.
(v) Checking of totalling and balancing of the ledger accounts and of the preparation of trial balance made with those balances.
(vi) Overall examination of writing up the transactions properly.

In short, routine checking is concerned with the ascertainment of the arithmetical accuracy of casting, posting and carry forward of balances.

Some are of the opinion that routine checking and vouching are the same. Again some other are of the opinion that they are complementary to one another. So, there is a need to examine the exact relationship between these two. Routine checking is confined to examine the arithmetic accuracy of the books of account. But vouching is done to find out errors and frauds and to know the authenticity, accuracy and reliability of books of accounts. The following points may be summarised in this regards:

(i) In a broad sense, routine checking is a part of vouching. Vouching includes routine checking i.e., checking of all totals, sub totals, carry forward, posting and checking of all ledgers.
(ii) The scope of vouching is much wider than routine checking. Routine checking is confined to the books of accounts only, whereas vouching may go beyond the books of accounts to trace the authenticity of the transactions.
(iii) Routine checking is limited to verify the arithmetical accuracy of the books, but vouching may require audit in depth or more investigation.
(iv) Routine checking can discover minor errors and frauds, but major frauds or planned frauds can be traced through vouching.
(v) Routine checking is normally done by the junior audit clerk, but the senior audit clerk used to perform vouching.

So, we can say that routine checking and vouching are not similar in nature and also do not complement to one another.

## 5.8 CONCEPT OF VOUCHER

Any document, which supports the entries in the books of accounts and establishes the arithmetical accuracy, is called a voucher. There is no denying the fact that without voucher, vouching cannot be conducted. Vouchers are considered as an integral part of vouching.

In other words, voucher is documentary evidence, both internal and external, which is used to support the entries made in the books of accounts of a business.

### 5.8.1 Examples of Vouchers

For every entry in the books of accounts, there should be a voucher supporting it. Receipt, invoice, cash memo, debit note, credit note, account sales, correspondence, counter-foils of cheque book & pay-in-slip, bank pass book, dividend warrant, wage sheets, agreements, a copy of purchase order, material requisition, minutes, resolutions are some of the important vouchers.

## 5.9 FEATURES OF VALID VOUCHERS

In general, a valid voucher should have the following features:

**(i) Amount** The amount written in the voucher must be same in words and in figures.

**(ii) Date** Every voucher must have a date.

**(iii) Client's Name** All vouchers must be in the name of the organisation or the client.

**(iv) Description of Transaction** Every voucher must contain the description of one transaction only.

**(v) Signature** Every voucher must be approved with signature by the competent authority.

**(vi) Clarity** Voucher must be flawless. That is to say, hazy or incomplete writings must not be included in the voucher.

**(vii) Countersign in Care of Alteration** If there is any alteration/correction performed on the voucher, it should be countersigned by competent authority.

(**viii) Serial Number** A voucher must have a serial number.

## 5.10 TYPES OF VOUCHER

On the basis of originality, voucher can be of two types:

**(i) Primary Vouchers** Written evidence in original is said to be the primary voucher. For example, invoice for a purchase.

**(ii) Collateral Vouchers** When the original voucher is not available, copies thereof are produced in support of subsidiary evidence in order to remove doubt from the mind of the auditor. Such a voucher is usually known as a collateral voucher. For example, Photo copy of demand drafts, counterfoil of pay-in-slip. etc.

On the basis of sources of documents, vouchers can again be of two types:

**(i) Internal Vouchers** Vouchers originating within the organisation are known as internal vouchers. For example, sales invoices, material requisition slip, goods received notes etc.

**(ii) External Vouchers** Vouchers originating from the outside sources are known as external vouchers. For example, bank statement, confirmation from customers and suppliers etc.

## 5.11 DUTIES OF AN AUDITOR FOR MISSING VOUCHERS

In the course of the audit, the auditor may find some vouchers missing. He must make a list of all the missing vouchers and should take the following steps in this regard:

**(i) Ask for Explanation** If any voucher is missing, the concerned official should be asked to give proper explanation. If no satisfactory explanation is received, it should be further investigated.

**(ii) Non-availability of Vouchers** Sometimes it is very difficult to collect some vouchers. For example, the vouchers of rickshaw-fare, taxi fare, retail purchase of some items, etc., in which case the auditor has to judge according to the circumstances.

**(iii) Materiality of Amount** The auditor should verify whether the amount involved is material. If the amount of the voucher is very small, then the auditor may not go for further clarification.

**(iv) Nature of Lost Vouchers** The auditor should examine the number and nature of transactions associated with the lost vouchers. If the number of transactions is very small, then the voucher may not be so necessary.

**(v) Causes of Loss of Vouchers** If the transactions are important, and the supporting vouchers are lost, then he must know the causes of loss of vouchers. In this respect, the auditor should follow the Doctrine of Materiality.

**(vi) Verification of Stores** In case of purchase of goods, if the voucher is not found, then he is to see whether the goods are stored, or issued to production department, or re-sold, or included in the closing stock.

**(vii) Duplicate Vouchers** In some special cases, the duplicate of original voucher is to be procured.

**(viii) Statement of Lost Vouchers Signed by High Officials** For all the lost vouchers, the auditor should make a statement of lost vouchers with the approval and signature of the higher authority.

**(ix) Declaration from Management** The Auditor should also obtain a declaration from the management that transaction pertaining to missing voucher are real and are undertaken in the interest of the organisation.

**(x) Reposting of missing vouchers** In case the number of missing vouchers are many and also of material in nature, he should mention the fact in his audit report. Even in extreme cases he may have to submit a disclaimer of opinion.

## 5.12 VOUCHING OF DIFFERENT ITEMS (RECEIPTS AND PAYMENTS RELATED)

In this section, we have summarised the procedure of vouching of different receipts and payment related items along with the documents required for the vouching. The section is divided into two parts. First, we shall discuss on vouching of receipt related items and then the vouching of payment related items.

### 5.12.1 Vouching of Receipt Related Items

#### A. Credit Sales (Sales Day Book)

The credit sales are recorded in the sales day book. The following steps are followed while vouching.

***Documents Required***

(i) Sales book/Sales register

(ii) Sales invoices
(iii) Goods outward book/Register
(iv) Transporter's receipt
(v) Purchase order from customers
(vi) Copy of the bill/challan
(vii) Stock records

***Procedures Followed/Duty of an Auditor***

(i) The auditor must be ensured that only the credit sales have been recorded in the sales day book.
(ii) He should thoroughly examine the effectiveness of the internal control system relating to credit sales.
(iii) He should compare the name of the goods, of the buyers, the date of sales, amount of sales, etc. recorded on the copy of the invoice with those mentioned in the sales book.
(iv) He should select a sample of invoices at random and apply audit in depth on them, i.e., follow the flow of work from the receipt of original order to the ultimate dispatch of goods and settlement of the account.
(v) He should ensure that printed numbers on the documents such as sales order, goods outward notes and sales invoices are being maintained sequentially. If any discrepancies found or for any missing numbers, he should ask for clarification.
(vi) Routine checking should be performed to ascertain the accuracy of totals of sales book and debtors' accounts and to check carry forward of totals and posting of entries in appropriate ledger accounts and then on to trial balance.
(vii) The sales tax, insurance charges, etc. collected through sales invoices must be recorded under separate accounts.
(viii) He should confirm that all the sales invoices have been recorded in the books.
(ix) Trade discount allowed to the customers should be checked. No separate entry for discount should be passed in the books.
(x) If there is any significant variation in trade discount allowed to different customers, the auditor is required to inquire into the reason for such variations.
(xi) The statement of account should be verified by obtaining confirmation from the customers.
(xii) The auditor should ensure that no sales of the last accounting year have been included in the current year's sales.

**B. Cash Sales**

***Documents Required***

(i) Cash memos (carbon copy)
(ii) Salesman's summary
(iii) Cashier's summary

(iv) Goods delivered summary
(v) Relevant accounting heads in ledger
(vi) Cash book
(vii) Daily cash sales statement

***Procedures Followed/Duty of an Auditor***

(i) The auditor should check the effectiveness and adequacy of the internal checks in the operations of the business.
(ii) He should examine the cash book with reference to daily cash sales summary and copies of cash memos.
(iii) He may select a sample of cash memos and go for audit in depth on them.
(iv) He should examine whether the prices charged, discounts allowed and rates of sales tax charged, as shown by cash memos are correct and properly authorised.
(v) He should compare the salesman's abstract with the carbon copies of cash memos.
(vi) He should examine whether the dates on cash memos and cash sales summary are the same.
(vii) The arithmetical accuracy of cash memos, cash sales summary and gate-keeper's goods delivered summary are to be checked by the auditor.
(viii) He should be ensured that no cancelled cash memo is torned out of the book.

**C. Collection from Debtors**

***Documents Required***

(i) Copy of sales invoices
(ii) Counterfoil of receipts
(iii) Statement of customers' accounts
(iv) Existing and past discount chart
(v) Correspondence with the customers

***Procedures Followed/Duty of an Auditor***

(i) First of all, the internal control system in respect of collection from customers is to be examined thoroughly.
(ii) The auditor should verify the amount received from customers with the counterfoils or carbon copies issued to customers at the time of receiving cash.
(iii) He should also examine whether the receipt book and the counterfoils of the receipt are kept in safe custody under a proper authority, whether all the receipt and counterfoils have been consecutively numbered, etc. In case of any cancelled receipt, it should be attached with the book without torning out.
(iv) The auditor should be ensured that amount received from customers has been entered in the cash book on the day it is received.
(v) He should take extra care while examining the discount allowed to debtors as there is a chance of misappropriation of cash by showing discount allowed to debtors. So,

the auditor should check the terms and conditions of discount allowed, whether it is approved by proper authority and whether uniformity of rate of discount is followed or not.

(vi) If necessary, the auditor can contact the customers directly with the approval of the client to verify the receipt of cash from them.

## D. Goods on 'Sale or Return' Basis

***Documents Required***

(i) Customer's order for sending the goods
(ii) Invoice for returning goods
(iii) Memorandum columnar book
(iv) Sales book
(v) Ledger (Customer's A/c)
(vi) Statements of customers giving details of inventories

***Procedures Followed/Duty of an Auditor***

(i) Firstly, the auditor should check whether the company maintain a separate memorandum record of goods sent out on sale or return basis.
(ii) The auditor has to ensure that goods sent are recorded along with the details of the customer.
(iii) He also has to ensure that the sales account has been credited only after the goods have been sold and correspondingly customer's account has been debited.
(iv) The auditor should refer to this book to ensure that on the receipt of acceptance from the customer, proper entries have been made in the sales book and the customer's account.
(v) If acceptance has not been received, but period of approval has expired, the goods at the end of the year should have been received back or customer's account should be debited.
(vi) All goods sent on approval, in respect of which time limit has not expired should be included in stock.
(vii) The auditor should get a statement from customer about the quantity and type of goods lying with him on approval basis.

## E. Goods on Consignment

***Documents Required***

(i) Consignment sales book
(ii) Carbon copies of proforma invoices
(iii) Account sales received from agent or consignee
(iv) Contact with consignee

(v) Correspondence, if any
(vi) Agreement between the consignor (client) and the consignee

***Procedures Followed/Duty of an Auditor***

(i) The auditor should verify the account sales submitted by the consignee showing goods sold and inventory of goods on hand.
(ii) He will also verify the copies of proforma invoices to know the price of goods sent out and expenses incurred on transportation and transit insurance of the goods.
(iii) The agreement between the consignor and the consignee should be verified to check the commission and other expenses which are credited to consignee account.
(iv) The Consignment Account is credited with amount of sales reported by the consignee and expenses incurred by him are debited to it along with expenses incurred by consignor. The auditor should examine account sales to verify such sales and expenses.
(v) He should ensure that expenses incurred by both the consignor and consignee have been posted to relevant nominal accounts and consignment sales to sales book or sales account in ledger.
(vi) Confirmation of the balance in the account of the consignee from the consignee should be obtained.
(vii) He should ensure that the goods sent on consignment remaining unsold at the date of balance sheet, has not been treated as goods sold.

**F. Bad Debts Recovered**

***Documents Required***

(i) Cash book/Bank passbook
(ii) Dividend warrant received from official receiver
(iii) Correspondences with the official receiver
(iv) Letter from collection agency
(v) Letters from debtors
(vi) Schedule of bad debts

***Procedures Followed/ Duty of an Auditor***

(i) The auditor should examine the receipt in the cash book with carbon copies or counterfoils of the cash receipt issued to the debtor or the trustee.
(ii) He should check that all the receipts have been posted in *Bad Debts Recovery Account* properly.
(iii) He should know from the dividend warrant received from the official receiver regarding the amount of total bad debt and the amount realised out of the total bad debt.
(iv) He should be ensured that the amount collected on account of bad debt recovery has been deposited into the bank promptly. The auditor should also ensure that all these receipts are serially numbered.

(v) He should vouch the bad debt recovered with dividend warrant, correspondences with the official receiver and counterfoil of cash receipt issued to the official receiver.

### G. Rent Received

***Documents Required***

(i) Agreement of rent
(ii) Cash book
(iii) Rent receipts
(iv) Rent bills
(v) Lease deeds/Tenancy vacant
(vi) List of properties being occupied
(vii) Counterfoils of pay-in-slips
(viii) Confirmatory letters from tenants
(ix) Correspondence with the lawyers
(x) Ledger (for relevant accounting heads)

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine the rent agreement and lease deed to know the amount of rent and the time of receiving the rent.
(ii) Examine the cash book for rent received with reference to the carbon copies counterfoils of rent receipts.
(iii) If the rent is received through the agent, the account of the collecting agent to be checked.
(iv) Examine copies of rent receipts issued to tenants with reference to rent bills raised by the client.
(v) Examine the rent receipts for details such as whether the date and amount of rent payable (as per tenancy agreement) and that of actual payment (as indicated by rent receipt) are the same.
(vi) The amount collected through rent receipts should be deposited into the bank account and the date and amount of such deposits should be checked with reference to counterfoils of pay-in-slips.
(vii) Vouch rent outstanding with reference to tenancy agreements, rent bills, confirmatory letters from tenants and list of properties occupied.
(viii) In case rents are doubtful, adequate provision for rent outstanding should have been made.
(ix) Check arithmetical accuracy of rent bills and rent receipts and ensure amount collected under various heads, e.g., taxes, water and electricity along with rent are posted to the correct accounting heads.
(x) The auditor should examine that proper adjustment has been made for any rent received in advance.
(xi) Investigation to be made for abnormal outstanding rent.

### H. Dividend and Interest Income

***Documents Required***

(i) Agreement of loan advanced
(ii) Cash book and bank passbook
(iii) Counterfoils of dividend/interest warrants or forwarding notes, etc.
(iv) Schedule of investments, loans and deposits
(v) Investment certificates
(vi) Dividend warrant
(vii) Investment register

***Procedures Followed/Duty of an Auditor***

(i) Dividend income is first vouched by the counterfoils of the dividend warrants and interest on securities by reference to tax deduction certificate issued by the Reserve Bank of India.
(ii) The auditor should examine the Investment Register and search for whether any dividend or interest is unrealised or not. He will ask for clarification, if any unrealised item found.
(iii) Examine the cash book for dividend and interest income received with reference to counterfoils of dividend/interest warrants or the forwarding note (received from the borrower along with the cheque/draft relating to interest broker's note in case of cum dividend/interest purchase of securities and such other relevant vouchers.
(iv) Trace a sample of dividend/interest received from the cash book through dividend/ interest warrants to investment certificates and their deposit into the bank.
(v) Vouch interest outstanding with records of investments and loans and examine its proper disclosure in accounts.
(vi) In certain cases, dividends and interest are received by the client after deduction of tax at source. The auditor should ensure that dividends and interests are recorded at gross amounts and tax deducted at source has been debited to Income Tax Account.
(vii) If interest or dividend is received for the pre-acquisition period, the auditor should see whether proper adjustment has been made with the cost of investment for this pre-acquisition dividend or interest.

### I. Commission Received

***Documents Required***

(i) Counterfoil of receipts/pay-in-slips
(ii) Cash book
(iii) Cash receipts
(iv) Agreement between the client and the third parties or account sales or bank advice

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine the agreement made between the client and the broker or agent or consignee.

(ii) Examine the receipts of commission in the cash book with counterfoils of the cash receipts.

(iii) Ensure that money has been deposited into the bank by reference to counterfoils of pay-in-slips.

(iv) Make all the necessary calculations himself and also examine posting to the appropriate ledger accounts.

(v) Examine the counterfoils of receipt of commission with reference to the agreement between the client and the parties from whom it is receivable or copy of account sales (in case of goods received on consignment) or bank advice (in case of commission received from abroad) and relevant documentary evidence in other cases.

### J. Insurance Claim Received

***Documents to be Checked***

(i) Cash book

(ii) Counterfoil of the receipt

(iii) Correspondence with the insurance company and the agent

(iv) Copy of claim lodged

(v) Insurance policy

(vi) Statement of claim submitted

(vii) Copy of the survey report

(viii) Copy of report/certificate containing full particulars of the loss suffered

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine the cash book entries for claims received with reference to counterfoils of the cash receipt issued to the insurance company.

(ii) He should examine the counterfoil of the acknowledgement of cash receipt issued by the client to know the actual amount recovered from the insurance company.

(iii) He should also check it with reference to the copy of *insurance claim lodged* and *correspondence* with the insurance company and the insurance agent. All the correspondences with the insurer on final determination of claim and payment thereof should be examined along with the copy of the survey report.

(iv) The accounting treatment of the amount received should be examined in order to ensure that revenue is credited with the appropriate amount and in the appropriate account.

(v) If there is any difference between actual loss and claim received, it should be debited to the profit and loss account.

## 5.12.2 Vouching of Payment Related Items

### A. General Approach

The following procedures are followed and documents are required in general for vouching of payment items.

***Documents Required***

(i) Cash book
(ii) Relevant documents
(iii) Bank statement

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine whether the cash memo against which payment has been made is in the name of the client, payment relates to the nature of business goods/ services mentioned therein are in conformity with specifications by the client and cash memo pertains to the period under audit.
(ii) Voucher should be supported by relevant documents, for example, voucher for payment shown in cash book for freight and carriage expenses should be supported by bill submitted by the transporter or the carriage company and receipts issued by them to the client.
(iii) The date, amount, serial number, account head, validity and arithmetical accuracy of the voucher should be checked.
(iv) Ensure that payment has been classified properly between capital expenditure and revenue expenditure.
(v) He should check that the payment is properly authorised.
(vi) Check that each entry in the bank column of the cash book can be traced to a corresponding entry in the bank statement.
(vii) Perform routine checks to establish the arithmetical accuracy of the cash memos and the cash book by verifying the totals, balances and carry forward of balances with the corresponding accounts in the ledger.

### B. Credit Purchases

***Documents to be Checked***

(i) Purchase book
(ii) Purchase requisition
(iii) Purchase order
(iv) Purchase invoices
(v) Goods received note
(vi) Copies of challan from the supplier

(vii) Goods inward register
(viii) Stock records

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine the transactions recorded in the purchase book with reference to related purchase invoice and other supporting documents attached to its purchase requisition, purchase order and receiving report or goods inward notes.
(ii) He should check whether the internal check system is in force and should examine that only credit purchases of goods are recorded in the purchase book.
(iii) He should select a small sample of vendors' invoices at random and conduct audit in-depth on them.
(iv) Ensure that numerical sequence of source documents such as purchase requisitions, purchase orders, receiving reports and vouchers have been maintained and missing numbers have been duly accounted for.
(v) He should examine whether the goods purchased have actually been received by the client. For the purpose, the goods inward register, stock records and challans from the supplier should be verified.
(vi) He should ensure that the purchase of goods is sanctioned by a responsible official and only those goods are purchased in which the organisation deals with.
(vii) The auditor should ensure that no credit purchase of previous year have been included in current year's purchase.

**C. Cash Purchase**

***Documents Required***

(i) Cash book
(ii) Cash memos
(iii) Stock ledger
(iv) Goods inward book
(v) Payment order
(vi) Original receipts from the payee

***Procedures Followed/ Duty of an Auditor***

(i) The auditor should ensure that payment for cash purchases has been vouched against the cash memo or receipted invoice issued by the suppliers.
(ii) He should verify that the goods purchased are actually received by the storekeeper. So, the entries in stock ledger should be verified as an evidence of the goods having actually been received.
(iii) He should perform routine checks to ensure arithmetical accuracy of transactions recorded.

(iv) The auditor should examine whether proper authorisation is there for purchase from the appropriate authority.

(v) He should ensure that there is adequate internal control system for the purchases of stores and stationery items on cash basis.

(vi) In case of discount received from suppliers, the net amount after discount needs to be recorded in the book. The auditor should check this.

### D. Purchase Returns

***Documents Required***

(i) Purchase return book
(ii) Goods outward notes/books
(iii) Debit notes
(iv) Advice note
(v) Original purchase invoice
(vi) Correspondence, if any

***Procedures Followed/Duty of an Auditor***

(i) The auditor should first examine whether a proper internal check system is there for transactions relating to purchase return.

(ii) He should examine the purchase return book with reference to copies of debit notes issued to suppliers and outward return notes.

(iii) The casting and posting of purchase return book and to ledger accounts to be checked.

(iv) He should examine the copies of debit notes with reference to goods outward return notes, original purchase invoice and advice note for returns.

(v) The auditor should ensure that the purchase returns have been properly authorised and the debit notes are prepared by the person authorised to do so.

(vi) He should also ensure that all the debit notes under consideration are related to the purchase returns of the period under audit only.

### E. Remuneration Paid to Directors

***Documents to be Checked***

(i) Articles of Association
(ii) Resolutions of the general meeting
(iii) Minute book
(iv) Agreement with the directors
(v) Director's attendance register
(vi) Receipts issued by the directors
(vii) Bank statements

***Procedures Followed/Duty of an Auditor***

(i) In general, the directors are not automatically entitled to remuneration. It is paid either according to the terms of Articles of Association or in accordance with a resolution of the general meeting. The auditor should examine the Articles of Association and resolution adopted in the general meeting in order to ascertain the mode of payment.

(ii) He should refer to general meeting or board meeting resolution for the appointment and terms of appointment of the director as per Section 196 of the Companies Act, 2013.

(iii) He should also check the agreement, terms and conditions of appointment of the directors.

(iv) Examine Articles of Association and general meeting resolution to determine the manner of payment—monthly or at a specified percentage of the net profits of the company or partly by one way and partly by the other as per the provisions of Section 197(6) of the Companies Act, 2013.

(v) The auditor should verify directors' attendance in the board meetings and in the minute book, if there is provision of payment of remuneration to the directors for attending the meeting.

(vi) He should ensure compliance with the provisions of Sections 197, 198 and Schedule V to the Companies Act, 2013 where appropriate regarding remuneration paid to the directors.

(vii) He should examine that the net profits and the commission payable to the directors has been computed in terms of Schedule III to the Companies Act, 2013.

(viii) He should ensure that a separate note has been given stating the computation of net profit under Section 198 of the Companies Act, 2013 with details of the commission payable as percentage of profits to the directors including Managing Directors/Manager (if any).

(ix) He should also examine adherence to relevant sections of the Act, such as

   (a) Section 309(3) and (4) which deals with manner of payment of managerial remuneration,

   (b) Section 309 (2) which deals with the payment of sitting fees,

   (c) Section 198 which has prescribed overall limits to managerial remuneration.

**F. Travelling Expenses**

***Documents Required***

(i) Cash book

(ii) Standard form for claiming reimbursement

(iii) Ticket of the mode of transport used

(iv) Hotel bill

(v) Travelling Allowance Rules of the organisation
(vi) Approved tour programmes
(vii) Tour report, if any

***Procedures Followed/Duty of an Auditor***

(i) The auditor should check whether there is any approved rule for travelling expenses to be paid to the staff. If no rule exists, he should recommend that rules may be framed to control the expenses.
(ii) The voucher for travelling expenses should normally contain the following information:
  (a) Name and designation of the person claiming the amount
  (b) Particulars of the journey
  (c) Amount of railway or air fare
  (d) Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station
  (e) Other expense claimed e.g. porterage, tips, conveyance, etc.
(iii) The auditor should examine the cash book for payments made for travelling expenses with reference to standard form for such reimbursement filled in by the claimant with his name and designation clearly indicated.
(iv) He should check the counterfoil of the air ticket, if the journey was undertaken by air. For travels by rail or road, the amount of the fare claimed should be checked from some independent source.
(v) He should ensure that the tour was sanctioned by proper authority.
(vi) Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified in terms of rules, if any, framed by the entity in this regard.
(vii) The evidence with regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable, it is usually not questioned.
(viii) All vouchers for travelling expenses should be authorised. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.
(ix) In case of foreign travel expenses, the auditor should also examine the Reserve Bank of India's prescribed foreign exchange entitlement for such travel along with company rules in this regard.
(x) The travelling advance taken, if any, should be settled on the receipt of final bills. At the year end, the amount not settled should be shown appropriately in the balance sheet.
(xi) Section 309 of the Companies Act, 2013 provides that the travelling expenses of the directors for attending board meeting are payable provided they have been allowed by the articles, or by a board's resolution or, if the articles so require, by a special resolution, passed by the company in the general meeting.

(xii) The auditor must examine the Directors' Travel Rules framed by the company, if any to ensure expenses are within the sanctioned limits.

## G. Wages and Salaries Paid

### *Documents Required*

(i) Cash book
(ii) Wage sheets/Pay-roll summary
(iii) Job cards
(iv) Returns submitted to various authorities
(v) Relevant registers
(vi) Authority letters
(vii) Schedule of unclaimed wages
(viii) Agreement of service
(ix) Salary bills
(x) Counterfoil of cheques

### *Procedures Followed/Duty of an Auditor*

(i) First of all, the auditor should ensure that an efficient internal control is in place.
(ii) He should examine the payments made for wages and salaries and shown in the cash book by reference to pay roll summary or wage sheets or salary register.
(iii) Pay roll summary of selected months will be taken for audit in depth.
(iv) The arithmetical accuracy of calculation of wages and salary to be ensured.
(v) He should examine the transaction in payroll/wage sheets with employee' time record/attendance records/leave records.
(vi) He has to ensure the rate or amount of wages and salaries is in accordance with legal regulations or contractual requirements.
(vii) The statutory deductions such as income tax, provident fund to be checked.
(viii) The auditor has to see whether the wage sheet and salary bill is duly certified by a responsible officer and to check the employment register for the purpose of finding out dummy employees and workers.
(ix) Proper attention to be given, if there are any cases of provisions relating to stock options, leave encashment, etc.
(x) He should compare the signatures of a sample of employees.
(xi) He should ensure that no employee is included in the pay-roll who have retired or left during the year.
(xii) He should ensure that proper authorisation have been obtained in case of employment of casual labour.
(xiii) He may conduct a surprise visit on the site of employment of casual labour to assess the accuracy of attendance records maintained at the site.

(xiv) Proper revenue stamp should be affixed in wage/salary sheet as per the government rule.

### H. Freight, Carriage and Custom Duty

***Documents Required***

(i) Freight note
(ii) Cash book expenses
(iii) Transport receipts
(iv) Rate schedule of transport charges
(v) Rate of custom duty
(vi) Custom duty payment challan
(vii) Statement of account
(viii) Receipt received from transporters

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine the payment shown in the cash book for freight and carriage expenses with reference to bills and statement of account submitted by the transporter.
(ii) He should check the arithmetical accuracy, if any rebate is there.
(iii) He should confirm that the bills are in the name of the clients.
(iv) The auditor should ascertain the nature of expenses first, i.e., whether they relate to the purchase of raw-materials or purchase of assets or sale of goods as the accounting treatment of these expenses depend on the purpose for which they have been incurred.
(v) He should ensure that the expenses incurred for acquiring fixed assets are properly capitalised.
(vi) He should confirm that all the expenses incurred in this connection are properly authorised.
(vii) The auditor should ensure that adequate transit insurance is there to cover the risk of loss due to goods lost in transit.
(viii) The auditor should also examine all the relevant documents and ensure that all the payments made in this connection have been fully accounted for.

### I. Preliminary Expenses

Preliminary expenses are the expenses that the company incurs for creation of the company prior to its incorporation. The examples are stamp duties, registration fees, legal costs, accountant's fees, cost of printing, etc.

***Documents Required***

(i) Resolution of the board of directors
(ii) Board's minute book
(iii) Receipts for the registration fees paid
(iv) Bills, receipts issued and statements

(v) Prospectus
(vi) Statutory report
(vii) Other supporting papers and vouchers

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine the contracts relating to preliminary expenses.
(ii) He should check the resolution of the board of directors and the power in the Articles, if preliminary expenses incurred by promoters have been reimbursed to them by the company.
(iii) All the documents supporting preliminary expenses like bills, statements, etc. should be examined.
(iv) The auditor should ensure that all the expenses capitalised as preliminary expenses are actually connected with the formation of the company.
(v) The auditor can cross check the amount of preliminary expenses with that disclosed in the prospectus, statutory report and the balance sheet.
(vi) He should ensure that shareholders approval has been taken for any expense in excess of the amount disclosed in the prospectus.
(vii) Underwriting commission and brokerage paid for shares and debentures should not be included under the head preliminary expenses.
(viii) The auditor should ensure that appropriate accounting standard and the accounting policy of the concern have been followed for writing-off of preliminary expenses.

## J. Donation

***Documents Required***

(i) Board's resolution
(ii) Resolution of general meeting
(iii) Profit and loss account cash book
(iv) Receipt of donation
(v) Articles of Association

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine the payments made for donation and shown in the cash book with reference to acknowledgement/receipt of donation.
(ii) He should ensure that payments made for donations are authorised by the proper authority.
(iii) He should also examine the Articles of Association of the company and board's resolution authorising payment of donations by the company.
(iv) The auditor should examine the resolution of the general meeting also. Approval of general meeting through a resolution is required where donations do not directly relate

to the business of the company or to the welfare of its employees and exceeds rupees fifty thousand or five per cent of average net profits.

(v) He should examine appropriate resolution of the board of directors and ensure that provisions of the Companies Act, 2013 including those with regard to adequate disclosure in profit and loss account of such amount have also been compiled with.

### K. Insurance Premium Paid

***Documents Required***

(i) Insurance policy
(ii) Insurance premium receipts
(iii) Demand letter
(iv) Correspondence with the insurance company
(v) Related papers and vouchers

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine both the insurance policy and the receipt received from the insurance company, if it is a new policy. For the old polices, only receipt received may be examined.
(ii) The auditor also examines the adequacy of insurance for the concern. The under-insurance or over-insurance should be checked periodically.
(iii) He should ensure that premiums are not in arrears and the prepaid insurance has been properly adjusted against subsequent premium payable.
(iv) He should confirm that the property belongs to the concern on which insurance premium has been paid.
(v) He should check that proper accounting treatment has been made for this.

### L. Payment of Income Tax

***Documents Required***

(i) Cash book
(ii) Receipt of challan
(iii) Assessment order
(iv) Assessment form
(v) Notice of demand for tax
(vi) Ledger (relevant accounts)
(vii) Permanent Account Number (PAN)/Tax Deduction and Collection Account Number (TAN) of the assessee
(viii) Bank passbook
(ix) Correspondence, etc.

***Procedures Followed/Duty of an Auditor***

(i) First of all, the auditor should clarify whether the tax paid are in advance or final.
(ii) He should examine the payment shown in the cash book for income tax with reference to a copy of receipted challan (a document acknowledging the amount of tax paid), copy of assessment order, assessment form and notice of demand.
(iii) Ensure posting of entries of amount paid to Income Tax Paid Account or to Advance Income Tax Paid Account in case of advance payment of taxes.
(iv) The interest allowed on advance payment of income tax should be included as income and penal interest charged for late payment should be debited to the interest account.
(v) In case of payment of final tax, it should be compared with the demand notice and assessment order of the Income Tax Officer.
(vi) He should examine whether proper provision has been made for payment of self assessment tax.
(vii) In case of electronic payment of taxes, it may be paid through online banking, debit card or credit cards.
(viii) Challan for making payment through electronic payment must clearly indicate the Permanent Account Number (PAN) of the assessee for whom the tax is paid.
(ix) If the payment has been made from the account of other person, the auditor should cross verify the receipted challan along with Permanent Account Number (PAN)/Tax Deduction and Collection Account Number (TAN) of the assessee.

### M. Payment of Dividends

***Documents Required***

(i) Proposals of the shareholders or directors for payment of dividend
(ii) Dividend register/book
(iii) Counterfoils of dividend warrants
(iv) Directors' or members' resolution
(v) Debenture trust deeds
(vi) Bank passbook
(vii) Memorandum of Association and Article of Association

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine the internal control of the company regarding the payment of dividend.
(ii) The auditor should verify the dividend paid with the counterfoil of dividend warrant.
(iii) He should examine the Board's minutes regarding rate of dividend.
(iv) He should check special provisions, if any, in the Memorandum and Articles of Association regarding payment of dividends.

(v) He should ensure that the provisions of the Companies (Declaration and Payment of Dividend) Rules, 2014 have been complied with in declaring dividends.

(vi) Examine the company's procedure for payment of dividends including unclaimed dividends and ensure that they are not paid without adequate safeguards like identification of the payee, checking of the payee's claims, etc.

(vii) He should verify the shareholders' register and ensure that the names of all shareholders who are entitled to receive dividends have been included.

(viii) Check the computation of dividends with reference to the rate of dividends and the number of shares held.

(ix) See counterfoils of cheques for the amount paid to shareholders.

(x) He should also examine, whether all the conditions for payment and source of dividend as specified under the Companies Act, 2013, have been complied with.

### N. Advertisement Expenses

***Documents Required***

(i) Schedule

(ii) Advertisement contract

(iii) Related bills, statements and vouchers

(iv) Statements of agency

(v) Bank statements

***Procedures Followed/Duty of an Auditor***

(i) First of all, the auditor should ascertain the nature of advertisement expenses to ensure that the same has been charged properly.

(ii) He should ensure himself that the advertisement expenses are related to client's business.

(iii) He should obtain a schedule indicating the mode of advertising along with details such as the amount spent, exact period, names of newspapers/television channels/ magazines, etc.

(iv) Compare the actual expenditure with budgeted one, if any.

(v) Examine the contract with the advertising agency and note down details such as rates, discounts, if any, period of the contract, fees, etc.

(vi) Ensure that regular statements are being received from the agency showing he amounts debited to the client.

(vii) Ensure that payments have been made to agencies against the bills and receipts obtained.

(viii) He should ensure that the outstanding advertisement expenses (if any) have been properly disclosed on the liability side of the balance sheet.

(ix) He should verify the amount paid by cheques to bank statements.

(x) Examine whether advertisement expenses have been allocated properly into revenue and deferred revenue category and only unamortised amount is being shown in the balance sheet.

### O. Research and Development Expenditure

***Documents Required***

(i) Bank statement
(ii) Relevant bills and invoices for research and development expenditure
(iii) BOD's resolution
(iv) Relevant ledger accounts
(v) Minutes of the board meeting
(vi) Memorandum and Articles of Association
(vii) Annual budget
(viii) Receipts and other relevant papers from the third parties

***Procedures Followed/Duty of an Auditor***

(i) The auditor should examine the payment in the bank statement with relevant documentary evidence. For example, expenditure incurred on material, during the development phase, with purchase invoices, salaries with salary register and so on.
(ii) He should examine whether such expenditure has been properly authorised. In case of a limited company, the auditor should examine the board of directors' resolution sanctioning such expenditure.
(iii) He should ensure that research and development expenditure has been made according to the objects of business of the entity.
(iv) The accounting entries passed for research and development expenditure are to be examined. He should ensure that if the research expenses are paid for developing products or for inventing a new product, they are treated as deferred revenue expenditure to be written off over a period of three to five years, if successful.
(v) If it is established that the research effort is not going to succeed, the entire expenses incurred should be written off to the profit and loss account.
(vi) If any plant and machinery have been purchased specially for the purpose of research activity, the cost thereof, less the residual value is appropriately debited to the Research and Development Account over the years of research.
(vii) The auditor should ascertain that appropriate accounting standard and the accounting policy of the concern in this regard have been followed.

## SUMMARY

- Vouching means careful examination of accuracy, authority and authenticity of transactions that appear in the books of original entry with the help of vouchers of these transactions.

- The basis of reporting the financial statement as 'true and fair' mostly depends upon the procedure and approach of vouching that is why vouching is termed as the 'essence of auditing' or 'backbone of auditing'.
- The main objective of vouching is to find out the accuracy and authenticity of the entries appears in the books of accounts. Vouching is done to check that all transactions recorded in the books of accounts are supported by documentary evidence and to verify that no fraud or error has been committed while recording the transactions.
- Routine checking is confined to examine the arithmetic accuracy of the books of account. But vouching is done to find out errors and frauds and to know the authenticity, accuracy and reliability of books of accounts.
- Any document, which supports the entries in the books of accounts and establishes the arithmetical accuracy, is called a voucher.
- On the basis of originality, voucher can be of two types i.e. primary vouchers and collateral vouchers. On the basis of sources of documents, vouchers can again be of two types: internal vouchers and external vouchers.
- In case of missing vouchers, the auditor must make a list of all the missing vouchers and should ask for explanation regarding causes of loss of vouchers. Materiality and the nature of the missing vouchers are also to be verified.
- Generally, the documents required for vouching receipt related items are: Sales book, Sales invoice, Cash book, Correspondence with customers, Contact with consignee, Letter from collection agency, Rent receipts, Schedule of investments, loans and deposits, Investment register, Counterfoil of receipts, etc.
- For vouching of receipt related items the auditor should thoroughly examine the effectiveness of the internal control system, sequence of maintaining books and register, the cash book with reference to daily cash sales summary and copies of cash memos, etc. He may select a sample of receipt items and go for audit in depth on them. He should ensure compliance with the provisions to the Companies Act, 2013 where appropriate regarding receipt related items.
- The document required in general for vouching of payments items are: Cash book, Bank statement, Purchase book, Goods inward register, Stock ledger, any correspondence, Articles of Association, Bank statements, etc.
- For vouching of payment related items, the auditor should check whether the internal check system is in force, should select a small sample of payment items and conduct audit in-depth on them, check that the payment is properly authorised, should perform routine checks to ensure arithmetical accuracy of transactions recorded, proper authorisation of the transactions, etc. He should ensure compliance with the provisions to the Companies Act, 2013 where appropriate regarding payment related items.

## EXERCISE

### A. Medium Answer Type Questions (4–6 marks)

1. Vouching of transactions is the essence of audit. Discuss.
   [*C.U. B.Com(H), 2012, 2014*]
2. State what information you would require and what documentary evidence you would see while vouching the director's remuneration. [*C.U. B.Com(H), 2000*]
3. State the information you would require and what documentary evidence you would see while vouching 'travelling expenses'. [*C.U. B.Com(H), 2001*]
4. What are the duties of an auditor regarding missing vouchers? [*C.U. B.Com(H), 2002*]
5. In vouching payment, the auditor does not merely seek proof that money has been spent. Discuss the statement. [*C.U. B.Com(H), 2003*]

### B. Essay Type Questions (8–10 marks)

1. How will you vouch the following? [*C.U. B.Com(H), 1990*]
   (a) Customs duty paid on import of machinery
   (b) Income from house property
   (c) Royalty payable to a foreign collaborator
   (d) Travelling expenses
2. How would you, as an auditor, examine the following? [*C.U. B.Com(H), 1991*]
   (a) Goods sent on sale or return
   (b) Goods sent on consignment
   (c) Payment of interest on share capital
   (d) Shares issued at discount
3. What do you understand by window dressing of balance sheet? What is the liability of an auditor in connection thereto? [*C.U. B.Com(H), 1991*]
4. In vouching payments, the auditors do not merely seek proof that money has been paid away—Critically examine the statement. [*C.U. B.Com(H), 1994*]
5. State what information would you require and what documentary evidence would you see while vouching the following? [*C.U. B.Com(H), 1995*]
   (a) Preliminary expenses
   (b) Freight, carriage and customs duty
   (c) Director's remuneration
   (d) Travelling expenses
6. How would you vouch the following items? [*C.U. B.Com(H), 1998*]
   (a) Preliminary expenses
   (b) Director's fees

(c) Insurance premium
(d) Interest and dividend received

7. In vouching payments, the auditor does not merely seek proof that money has been paid away—Discuss. [*C.U. B.Com(H), 1999*]
8. Information and means of Information are by no means equivalent terms—Explain. [*C.U. B.Com(H), 2001, 2005, 2006, 2012*]
9. Are routine checking and vouching complementary to each other? What are the common features of valid vouchers? [*C.U. B.Com(H), 2002*]
10. How will you vouch the following items? [*C.U. B.Com(H), 2006*]
    (a) Preliminary expenses
    (b) Director's remuneration
    (c) Payment of insurance premium
    (d) Payment of dividend
    (e) Travelling expenses
11. Do you think that routine checking and vouching are complementary to each other? As an auditor how would you vouch the following? [*C.U. B.Com(H), 2013, 2014, 2016*]
    (a) Preliminary expenses
    (b) Travelling expenses
    (c) Commission brokerage to travelling salesmen
12. As an auditor how would you vouch the following? [*C.U. B.Com(H), 2016*]
    (a) Preliminary expenses
    (b) Sales return
13. How would you vouch the following transaction? [*C.U. B.Com(H), 2013, 2015*]
    (a) Payment of wages
    (b) Payment of Salary
    (c) Director's Remuneration
14. How would you vouch for the following? [*C.U. B.Com(H), 2016*]
    (a) Purchase of Land and Building
    (b) Purchase of Plant and Machinery
    (c) Purchase of Investments

# 6 CHAPTER — VERIFICATION AND VALUATION

## CHAPTER OUTLINE

**6.1** Verification
**6.2** Window Dressing and Verification
**6.3** Difference between Vouching and Verification
**6.4** Valuation of Assets and Liabilities
**6.5** Difference between Verification and Valuation
**6.6** Verification and Valuation of Assets
**6.7** Verification and Valuation of Liabilities

## 6.1 VERIFICATION

### 6.1.1 Background

Verification is an important part of the audit process. The auditor has to give a certificate on the accounts examined by him that the Profit and Loss Account shows the true and fair view of the profit or loss of business and the Balance Sheet shows a true and fair view of the state of affairs of the business (as per Section 143 of the Companies Act, 2013). Hence, it becomes the duty of the auditor not only to vouch the expenses and incomes, but also to verify and check the valuation of the assets and liabilities of business. The proof of evidence of existence of any asset or liability cannot be assured by examining the documentary evidence, i.e., through vouching only, physical verification or inspection is also required for confirming the existence. Simply verification means the proof of existence or conformation of assets and liabilities on the date of balance sheet.

### 6.1.2 Concept and Definition of Verification

Verification means verifying the truth of the existence, values and ownership of the assets.

Before signing his report, the auditor has to satisfy himself that the assets shown in the balance sheet really exist, they are in the name of his clients and the values shown are proper. The process of satisfying himself regarding all these points is 'verification'.

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

According to *Joseph Lancaster*, "Verification of assets is a process by which the auditor substantiates the accuracy of the right-hand side of the Balance Sheet, and must be considered as having three distinct objects: (a) the verification of the existence of assets (b) the valuation of assets and (c) the authority of their acquisition".

So, verification of assets can be stated as a process of substantiation of assets recorded in the books of account, by means of physical inspection and examination of legal and official documents, and then forming expert opinion as to the existence, ownership, possession, classification and valuation of assets of an entity.

Management is primarily responsible for verification of assets as the proprietor or the officials of the entity are expected to have a much greater intimate knowledge of the assets of the business as regards location, condition, etc. than that which an outsider might be able to acquire on their inspection. They alone thus are competent to determine the values at which these should be included in the balance sheet. The auditor's function in this circumstances is limited only to an appraisal of the evidence, their inspection and reporting on matters affecting their valuation, existence and title, observed in the course of such an examination. Principally, the auditor is required to verify the original cost of assets and to confirm, as far as practicable, that such a valuation is fair and reasonable. As regards the manner in which the original cost should be ascertained, there are well defined modes of valuation which he is expected to follow.

### 6.1.3 Objectives of Verification

Verification of assets and liabilities is undertaken with the following objectives:

(i) **Existence** To find out whether the assets that are shown in the balance sheet are in existence or not.

(ii) **Ownership** To find out the ownership, possession and title of the assets. To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business.

(iii) **Correct Valuation** To show correct valuation of assets and liabilities.

(iv) **Valued on GAAP** To see that assets and liabilities are valued on the basis of generally accepted principles and that valuation is consistent with that of previous year.

(v) **True and Fair View** To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business.

(vi) **Check Fraud and Irregularity** To check that whether any fraud or irregularity are committed in connection with any asset or liability.

(vii) **Adequecy of Internal Control** To find out whether there is an adequate internal control regarding acquisition, utilisation and disposal of assets.

(viii) **Arithmetic Accuracy** To verify the arithmetic accuracy of the accounts.

(ix) **Proper Recording** To ensure that the assets have been recorded properly.

(x) **Included in Balance Sheet** To verify that all the business assets and liabilities are included in the balance sheet and no item is left out.

(xi) **Related to Business** To verify that the assets and liabilities not connected with business are not shown in the balance sheet.

### 6.1.4 Importance of Verification

Assets and liabilities are very important aspects of business. Balance sheet is prepared on the basis of them and an auditor should verify the truth and fairness of information provided by balance sheet. It is not enough to vouch the transactions relating to assets and to verify the arithmetical accuracy. So, it is required to verify the actual existence, ownership and valuation of the assets and liabilities. Most of the fixed assets should be revalued as their value decreases due to normal wear and tear in the business as well as there may be transaction like sale or purchase or leasing of any assets. So, it is important to know whether the value of the assets and liabilities shown in the balance sheet are correct or not. The importance of the verifications can be summarised as follows:

#### A. To Know the Ownership

Ownership of the assets should be verified by examining the title deeds. In case the title deeds are held by other persons such as solicitors or bankers, confirmation should be obtained directly by the auditor through a request signed by the client. In case of assets without any document to title, such as debtor, cash and work progress, the auditor should verify the ownership by designing audit procedures to ascertain the efficacy of internal control system.

#### B. To Show the Actual Financial Position

Balance sheet is prepared to show the actual financial position of a business. If proper valuation is not made, such balance sheet does not provide true and fair information. So, to provide information about the real financial position, verification and valuation of assets are essential.

#### C. To Know the Real Position of Profit and Loss

Depreciation and other expenses on assets will be incorrect, if proper valuation of assets is not made. So, to calculate the actual amount of profit and loss, proper valuation of assets and liabilities is necessary.

#### D. Possession

The auditor should ascertain that the assets are in the possession of the client. If any asset is in possession of any other person, it should be seen that such possession has been duly authorised by the client.

#### E. Existence

The physical verification of fixed assets is primarily the responsibility of the management and not the auditor. In order to verify the existence of assets, he should examine the records with reference to the documentary evidence and the internal controls.

#### F. Valuation and Disclosure

The auditor should satisfy himself that the assets have been valued and disclosed in the financial statements according to the generally accepted accounting principles and statutory requirements, if any.

#### G. Adequate Disclosure of Encumbrances or Lien

The duty of an auditor with regards to such disclosures is two folds—firstly, he should adopt audit procedures to ascertain whether any asset is subject to charge. Example of some such procedures are representations obtained from the management and confirmation obtained from the bank with regards to the purpose of holding securities. Secondly, if a charge exists, the auditor should ensure its proper disclosure in the financial statement.

### 6.1.5 Advantages of Verification

The main advantages of verification are:

(i) It avoids manipulation of accounts.
(ii) It guards against improper use of assets.
(iii) It ensures proper recording and valuation of assets.
(iv) It exhibits true and fair view of the state of affairs of the company.

### 6.1.6 Steps in Verification

Verification has the following steps:

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

**(ii) Observation** The auditor may observe or witness the inspection of assets done by others.

**(iii) Confirmation** It means obtaining written evidence from outside parties regarding existence of assets.

## 6.2 WINDOW DRESSING AND VERIFICATION

Window dressing is a technique used by companies and financial managers to manipulate financial statements and reports to show more favourable results for a period. Window dressing is usually done to mislead investors.

Companies typically window dress their financial statements by selling off assets and either purchasing new assets or using this money to funds other operations. This way the cash balance on the balance sheet appears to be at a normal amount. Unfortunately, this strategy can only fool novice investors. Experienced investors can analyse the statement of cash flows and long-term assets to see that the company is funding current operations by selling off assets.

Window dressing is probably most commonly found in investment brokers and mutual fund houses. Mutual fund managers often sell off poor performing stock and other investments near the end of a period and use the money to buy high performing stock. This way, new investors see the portfolio of high performing stock and want to invest. Obviously, this is only a short-term strategy for novice investors. Any experienced investor will analyse portfolio trends over the past few periods to see, if the fund's managers are investing wisely.

In short, window dressing is a short-term strategy to make financial statements and financial portfolios appear more consistent and desirable than they really are. Although window dressing does not amount to fraud in most circumstances, it is usually done to mislead investors from the true company or fund performance. It is the duty of the auditor to carefully verify the existence of the assets and liabilities. He should ensure that no attempts have been made by the client to adopt window dressing. It may sometimes happen that the client may show a particular asset in paper only which, in fact, does not exist physically. The auditor should conduct effective and detail verification work to identify window dressing, if any.

## 6.3 DIFFERENCE BETWEEN VOUCHING AND VERIFICATION

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

**Difference between Vouching and Verification**

| S.No. | Points of Distinction | Vouching | Verification |
|---|---|---|---|
| 1. | Meaning | Vouching means substantiating an entry in the books of account with the supporting vouchers like receipts, invoices, correspondence, contracts, etc. | Verification means examining with regard to the assets shown in the balance sheet that they exist, are in the name of the company, are properly valued and are free from any charge. |
| 2. | Area of checking | In vouching, the auditor examines the bonafides of transactions and their correct recording in the books. | In verification, the auditor has to ensure that assets as recorded in the balance sheet do really exist on the date of the balance sheet. |
| 3. | Assurance about existence | Vouching cannot ensure the existence of assets. After purchase of the assets, it may be sold, destroyed or even gifted away without being recorded in the books. | Verification ensures the existence of the assets through physical impelling of the place where the assets are located. |
| 4. | Related area | Vouching is concerned with all issues of income statement and with those balance sheet items undergoing change during the year. | Verification is concerned with all the items of balance sheet. |
| 5. | Existence of assets | In vouching, the auditor comes to know what should be in existence. | In verification, the auditor can know the actual existence, freedom encumbrances and proper valuation of assets. |
| 6. | Frequency | Vouching is done at any time during the year. | Verification is done only after accounts are completed and balances are drawn. |

## 6.4 VALUATION OF ASSETS AND LIABILITIES

As we have seen earlier, an auditor is required to certify that the balance sheet shows true and fair view of the company's affairs. Naturally, if the assets and liabilities are shown at their proper values, the balance sheet would be true and fair. Hence, the auditor has to satisfy himself that the assets are shown in the balance sheet at their true and fair values. Now the problem is what the correct value of an asset is. The assets would be deemed to be properly valued, if valuation is made according to the generally accepted accounting principles.

Valuation of assets means the examination of the accuracy and propriety of the valuation of those assets, which are shown in the balance sheet of any concern at the end of the financial year.

So, valuation is an operation, which includes:

(i) obtaining all the necessary information regarding valuation,

(ii) analysing all the figures available,
(iii) confirming the fact that the valuation is being determined on the basis of generally accepted conventions and accounting principles,
(iv) ensuring the consistency of the methods followed for the valuation from year to year, and
(v) obtaining an opinion regarding the accuracy of valuation.

### 6.4.1 Challenges in Valuation

The auditor faces the following problems while conducting valuation of assets and liabilities:

#### A. Determination of Correct Estimated Life

The valuation of assets is made on the basis of estimated life of the assets. However, the determination of estimated life is not an easy task.

#### B. Problems Due to Inflation

As price level changes every year, it is a complicated job to ascertain the correct value of the assets in changing price level after considering the inflation.

#### C. Identification of the Character of the Assets

In some cases, it is not possible to identify the character of the asset for the purpose of valuation as whether it is fixed asset or current asset. The mode of valuation of fixed assets is different from the mode of valuation of current assets, e.g., investments.

#### D. Events Occurring after Balance Sheet Date

It is not possible for the auditor to take into consideration the events occurring after the balance sheet date, which have the effect on valuation of assets.

#### E. Lack of Information

The auditor may not be in possession of all the relevant information which is required to be considered for the determination of the value of assets.

#### F. Changing Accounting Standard

The auditor's job has been tougher in recent times due to continuous changes in accounting standards, regulation and act for valuation of assets and liabilities. So, they have to keep themselves updated and proper care should be taken for valuation.

#### G. Use of Assets

In some situations, the same asset is available for sale and again is used in the organisation. The valuation process also depends on the nature of use of the concerned assets, e.g., stock of furniture.

### 6.4.2 General Principles for Verification of Assets

It is not sufficient for the auditors only to verify correctness of the amount of assets shown in the balance sheet, he must verify them by actual inspection or otherwise and establish the existence of assets. Points requiring auditor's attention for verification are as under:

#### A. Cost

In regard to assets, verification procedure need not generally be extended to determination of the correctness of costs and authority to incur costs unless the items concerned were purchased during the accounting period under review. In such cases, the auditor should check the correctness of costs through normal vouching methods. He should ensure that adequate distinction has been made between revenue and capital nature of costs.

#### B. Acquisition of Individual Asset

The cost of asset acquired should be verified with their purchase agreements or ownership rights and the receipts of the seller in respect of the price paid. It should be verified that expenditure on assets newly acquired and that on the renewal and replacement of old assets has been correctly recorded consistent with the method that has been generally followed in the past.

#### C. Acquisition of Group of Assets

Where a company or a partnership has taken over the assets of a going concern, the agreement of sale should be inspected and the amount paid for them be ascertained. It should be further verified that the allocation of the total cost among the various assets is fair and reasonable.

#### D. Sale of Assets

When an asset is sold, its sale proceeds should be vouched with respect to the reference to the agreement, containing the terms and conditions of sale, counterfoil of the receipt issued to the purchaser or any other evidence which may be available.

If the sale of a fixed asset has resulted in capital profit, it should be transferred to capital reserve. However, the profit limited to the original cost or a loss should be transferred to the profit and loss account.

#### E. Valuation

It must be ascertained that all assets are valued in accordance with appropriate accounting policy. For the valuation made, the basis must be consistently applied, unless circumstances necessitated a change. Even then a disclosure is required for the change and its monetary effect.

#### F. Depreciation

It is obligatory for a company to provide for depreciation out of the profits in accordance with the provisions under Sub-section (1) of Section 123 of the Companies Act, 2013 before any profits can be distributed as dividend. The law requires that depreciation should be provided in the manner as specified in Scheduled II to the Companies Act, 2013.

### G. Physical Verification of Fixed Asset

The existence of fixed assets, where practicable, should be verified by physical inspection or by comparing the particulars of assets as entered in the schedule attached to the balance sheet, with the Asset Register and also reconciling their total value with the general ledger balances.

### H. Existence

Where physical inspection is not possible, the possibility of obtaining indirect evidence be considered e.g. machinery imported held in customs godown or materials sent to subcontractor for job work or fabrication. In such circumstances, confirmation of such parties should be obtained, and if considered necessary, even physical verification may be requested.

### I. Presentation in Accounts

Material assets must be properly disclosed and correctly described in the accounts. It should be seen that the description given to them is clear and complete and is not misleading, e.g., stating loans on the assets side of the balance sheet "as dependent upon realisation" is just misleading as was held in the case of London and General Bank Ltd. Care must be taken to see that disclosures required under the statute or statement issued by ICAI are complied with.

### J. Inspection of Current Assets and Investments

Wherever possible, all the securities and documents of title, cash, negotiable instruments etc. representing the assets should be inspected at the close of the last day of the accounting period. If this is not practicable and the examination is undertaken at a latter date, a careful scrutiny of transactions subsequent to the date of the balance sheet must be made to ensure that the changes in their balances that have subsequently taken place are bonafide and are supported by adequate evidence.

### K. Charges on Asset

It should be ascertained that no unauthorised charge has been created against an asset and all the charges are duly registered and disclosed.

Where shares or securities are lodged with a bank to secure a loan or an overdraft, a certificate should be obtained from the bank showing the nature of the charges, if any.

### L. Assets with Third Parties

Where assets, for example, government securities, share and debentures, stock sent on consignment, goods sent on sale or approval basis, etc. are in the custody of a third party other than a bank, these must be inspected.

### M. Separate Disclosure

Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

## 6.5 DIFFERENCE BETWEEN VERIFICATION AND VALUATION

Valuation of assets is a part and parcel of verification. Without proper valuation of assets, verification is not possible. Verification includes, apart from valuation, the examination of ownership right, the existence of the asset in the business and its freeness from any sort of charge or mortgage.

**Differences between Verification and Valuation**

| S.No. | Points of Difference | Verification | Valuation |
|---|---|---|---|
| 1. | Concept | Verification is concerned with the examination of the ownership right of the assets of an entity, their existence and possession along with their valuation. | Valuation is concerned with the determination of value of the assets and liabilities of an entity at which it will be disclosed in the balance sheet. |
| 2. | Function | Verification deals with the assessment of the genuineness of the ownership title and valuation of the assets of an entity. | Valuation deals with only the assessment of rightness of the methods of valuation at which different assets and liabilities are valued. |
| 3. | Scope | Verification is a broader concept. It includes among different other aspects, the valuation part of assets and liabilities. | Valuation is a narrower concept as compared to verification, because it is only a part of the whole process of verification. |
| 4. | Objective | The main objective of verification is to ascertain whether the assets and liabilities owned by the entity are correctly disclosed in the financial statements at their proper value. | The main objective of valuation is to ensure that the assets and liabilities of the entity are correctly valued by the following the prescribed norms of the competent authority. |
| 5. | Nature | The nature of the work involved in the verification process is to some extent complicated as it involves assessment of legal ownership as well as possession of the assets by the entity. | Valuation process, on the other hand, involves the determination of value of the assets and liabilities as per the prescribed norms and guidelines. |
| 6. | Interdependence | Without proper valuation, the verification process cannot be completed. So, verification is dependent on valuation. | Valuation is a process, which facilitates proper verification of assets and liabilities. Without valuation, verification cannot be completed. |
| 7. | Services from other experts | Verification work usually does not require services form other experts by the auditor. | Valuation work requires the services of other experts, because the auditor is not a valuer in true sense. |
| 8. | Certificate for the work | Auditor is not supposed to issue a separate certificate for verification of assets and liabilities of an entity. | If an expert's service is sought for the proper valuation of assets and liabilities, the concerned expert is supposed to give a certificate for the valuation he has done. |

## 6.6 VERIFICATION AND VALUATION OF ASSETS

Verification of asset is an important audit technique. Conventionally, the scope of this technique is limited to inspection of assets and collection of information about the assets. It is the duty of the management to ensure that the fixed assets of the company are in existence and for this purpose, it is important that physical examination of plant and machinery and other fixed assets should be carried out periodically depending upon the size of the company. The auditor is also required to report on the physical verification of the fixed assets by the management, and the treatment of the discrepancies, if any.

For the purpose of applying verification techniques, we may divide the assets into the following four categories:

(i) Tangible assets, viz. land & building, plant & machinery, furniture & fixtures, motor vehicles, etc.
(ii) Intangible assets, viz. goodwill, patent, trade mark, copyright, etc.
(iii) Current assets, viz. stock-in-trade, sundry debtors, cash and bank balances, etc.
(iv) Other assets, viz. preliminary expenses.

### 6.6.1 Audit of Tangible Assets

The Guidance Note on Audit of Property, Plant and Equipment issued by the ICAI recommends that verification of PPE (refer to Ind AS-16) consists of examination of related records and physical verification. The auditor should, normally, verify the records with reference to the documentary evidence and by evaluation of internal controls. Physical verification of PPE is primarily the responsibility of the management. The auditor must also consider the appropriateness of the accounting policies, including policies for determining which costs are capitalised, whether a cost or valuation model is followed and depreciation (including assessment of residual values) appropriately calculated. The verification of records would include verifying the opening balances of the existing PPE from records such as the schedule of fixed assets; ledger or register balances to acquisition of new fixed assets should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds.

Note 6(I) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Tangible Assets" in notes to accounts as follows:

(I) Tangible Assets: Classification of tangible assets shall be given as–

   (a) Land
   (b) Buildings
   (c) Plant and equipment
   (d) Furniture and fixtures

(e) Vehicles
(f) Office equipment
(g) Others (specifying nature)

The Clause (i)(a) to Paragraph 3 of the Companies (Auditor's Report) Order, 2015 [CARO-2015] requires the auditor to comment whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets.

## Verification of Specific Assets

### A. Freehold Land

Freehold land is the land which is 'free from hold' of any entity besides the owner. Hence, the owner of such a land enjoys free ownership for perpetuity and can use the land for any purposes, however, in accordance with the local regulations.

#### *Verification*

The duties of an auditor in verifying freehold land is as under:

(i) Inspect the original title deed and conveyance or purchase deed which should be in the name of the owner.
(ii) The auditor should obtain a certificate from the legal advisor of the client confirming the validity of the title to the property.
(iii) He should also verify that the conveyance deed has been duly registered as required by the Indian Registration Act and the particulars to be endorsed thereon have been duly endorsed.
(iv) If the land is mortgaged, the title deed would be in the possession of the mortgagee. A certificate to this effect should be obtained from the mortgagee or his lawyer.
(v) If any charge or encumbrances exist on land, the auditor should ensure that they have been properly disclosed.

#### *Valuation*

(i) Land is a non-depreciable asset. It is generally shown in the balance sheet at historical cost which includes purchase price, broker's commission, stamp duties, registration fees, legal charges and also levelling, clearing and draining charges.
(ii) Where payments are made to the municipality for constructing sidewalks, laying of sewers, etc. such costs should, preferably, be shown separately in 'Land Improvement Account' and adequate depreciation should be provided for on it.
(iii) If land and building were purchased as a package, the auditor should determine their values separately. For the said purpose, he should review documents such as appraisal report by valuers and tax assessment valuation report which can provide a basis for apportionment of costs between land and building.

### B. Building

***Verification***

(i) The auditor should verify the title deed of buildings to see whether the client holds the title on the balance sheet date.

(ii) If the building has been built or is in the course of construction, under a contract the auditor should verify the balance against architect's certificate and the amount paid to the contractor.

(iii) If the building has been constructed by the client's own organisation, the auditor should justify the expenses of cost of material, wages and the supervision charges.

(iv) If the building has been mortgaged, the title deed will be in the possession of the mortgagee from whom a certificate should be obtained.

(v) The auditor should see the relevant particulars of buildings have been entered in the fixed assets register maintained by the client.

***Valuation***

(i) The building should be valued at cost less depreciation.

(ii) If no depreciation is provided on the building, a note to this effect should be given in the profit and loss account.

(iii) If the building is purchased the original cost of the building should be verified with the deed of conveyance.

(iv) Ascertain the reasonableness of basis used to calculate the cost of building whether it is purchased or constructed.

(v) If any revaluation has taken place, the auditor should verify the basis of revaluation and ensure that the disclosure of the same has been made.

### C. Land and Building

It may be the situation that the land and building have been shown together in the balance sheet. In this case, the auditor should consider the following issues while verification.

***Verification***

(i) The auditor should examine whether the ledgers have been maintained separately for land and building or not, as buildings are subject to depreciation while land in general is not.

(ii) He should verify the land holdings through an inspection of the original title deed to ensure that the land described therein covers all the lands the cost of which is debited in the books of the concern.

(iii) He should obtain a certificate from the legal adviser of the client confirming the validity of his title to the land.

(iv) The auditor should, however, verify that the conveyance deed has been duly registered as required by Section 17(1) of the Registration Act, 1908.

(v) If the property has been mortgaged, the title deed will be in the possession of the mortgagee from whom a certificate should be obtained.

(vi) The auditor should also verify whether there is any second or subsequent mortgage.

(vii) If there has been any sale of land and building, it should be verified that the amount of profit or loss resulting on sale has been correctly adjusted in the accounts.

***Valuation***

The cost of fittings and fixtures to the building should be adjusted separately in the account from the cost of buildings, since these suffer higher rate of wear and tear than the brick and mortar structure and, therefore, have to be depreciated considering lesser useful lives. The auditor should take the following into consideration for ensuring proper valuation of land and building:

(i) If the values of land and buildings are not separately recorded in the books of account, the same should be separated for purposes of calculating the amount of depreciation. This should be done with the assistance of a valuer, unless the same can be achieved on the basis of some documentary evidence available in the record.

(ii) Since buildings are continually repaired and there is only a thin margin of differentiation between the expenditure of their improvement and that on repairs, it is necessary for the auditor to scrutinise closely the expenditure on repairs.

(iii) Such expenditure should be added to their cost while the amount incurred on current repairs is written off.

## D. Leasehold Property

A leasehold property is an ownership of a temporary right to hold land or property in which a lessee or a tenant holds right of a real property by some form of title from a lesser or landlord or property owner.

***Verification***

The steps involved in the verification of leasehold rights are as stated below:

(i) Verify the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions.

(ii) The auditor should also ensure whether the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument (Section 107 of the Transfer of Property Act, 1882).

(iii) Ensure that all the conditions of the lease have been complied with e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc.

(iv) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.

(v) He should confirm himself any writing off of any legal expenses incurred to acquire the lease over the unexpired term of the lease.

***Valuation***

(i) The leasehold property has been shown in the balance sheet after deducting the depreciation.
(ii) The auditor should check the value of the leasehold property from the lease deed. Any addition or expansion thereon should be examined by reference to the contractor's bills and other supporting papers.
(iii) The auditor should ensure that the provision for any claim that might arise under the dilapidation clause on the expiry of the lease has been made.
(iv) He should also check the accounting of leasehold property to ensure himself that it is maintained separately.
(v) It the property has been let out, examines whether the rent has been collected in time and recorded in the books properly.

**E. Plant and Machinery**

Inspect plant register which contains detailed particulars relating to various plants, machines and equipment along with their original cost, rate and amount of depreciation, accumulated depreciation, additions and sale from time to time.

***Verification***

(i) Prepare a statement from the plant register showing opening balance, sale and addition thereto during the year in respect of various items of machinery and plants. Its total is then reconciled with the balance in the general ledger.
(ii) Ensure that the management has physically verified the plant and machinery. The auditor should ask for the related working papers for his examination.
(iii) In the absence of a plant register, the auditor should verify the register containing detailed particulars of various articles of machinery and equipment, showing separately original cost, addition to and sales from it from time to time.
(iv) If there is any addition or disposals in the plant and machinery, it should be verified with the invoices, other incidental expenses, including installation expenses and other appropriate documents.

***Valuation***

(i) Plant and machinery should be valued at cost of acquisition less depreciation.
(ii) The auditor should check as to whether any of the items has been disposed of or sold during the year. In case of any sale, he should examine that it was properly authorised and the sale proceeds credited to the plant and machinery account. Any capital profit made should be transferred to capital reserve.

(iii) In case any item or machinery has been scrapped, destroyed or sold, the auditor should ascertain that the profit or loss arising thereon has been correctly determined which has either been disclosed in the statement of profit and loss or credited to the capital reserve.

(iv) The auditor should confirm the existence of lien or floating charges, if any, by inspecting the register of charges.

(v) Verify that the plant and machinery has been properly shown under fixed assets in the balance sheet.

### F. Furniture, Fittings and Fixtures

***Verification***

(i) Verify the stock register which has details regarding the date of purchase, cost of furniture and fittings, depreciation rate, location, stock number allotted to it and other issues.

(ii) The cost of these assets should be verified by reference to the invoices of suppliers. The entire expenditure related to their purchase also should be debited to the appropriate asset account.

(iii) It should be verified that each article of furniture is entered in an inventory register before its price is paid.

(iv) Ensure stock number is painted or affixed on the furniture and fittings.

(v) He should inquire whether physical verification of the furniture and fixtures has been carried out by the management and, if so, he should examine the working papers.

(vi) The auditor should carefully scrutinise the details of the cost of additions and sale proceeds of any disposals.

(vii) In the case of assets in regard to which there is a danger of loss through pilferage, there should be a satisfactory system of inventory control over them.

***Valuation***

(i) The assets are valued at cost less depreciation.

(ii) Ensure that cost of furniture and fittings, which have become unserviceable, has been written off to profit and loss account under proper authority.

(iii) The auditor should see that the cost of furniture and fixture has been properly ascertained and recorded in the books of accounts.

(iv) If there is any sale of assets or any asset is disposed of, the auditor should verify whether it was properly authorised and whether the sale proceeds have been credited to the furniture and fixture account. Any capital profit made therein should be transferred to capital reserve.

(v) The auditor should also verify that furniture and fixtures have been properly shown under fixed assets in the balance sheet.

### G. Motor Vehicle

In case the number of vehicles is large, there should be a vehicle register similar to the plant register.

***Verification***

(i) Examine registration certificate of which contains information relating to ownership, identification of the vehicle and other important details.
(ii) He should compare the registration number and description given in the registration document with the particulars shown in the ledger account or motor vehicle register.
(iii) The cost of these assets should be verified with reference to the invoices of suppliers and their ownership confirmed from the permit and registration books.
(iv) The auditor should verify insurance policies taken for motor vehicles and road tax receipt for verifying the safety of the assets and its ownership.
(v) He should also examine whether adequate depreciation has been provided in respect of each of motor vehicle.

***Valuation***

(i) The motor vehicles are to be valued and disclosed at the cost less depreciation.
(ii) The cost of motor vehicle includes purchase price and cost of accessories.
(iii) The cost price of any motor vehicle will be vouched with supplier's invoices and other supporting documents.
(iv) However, he should see that expenditures on repair have been charged to profit and loss account and not added to its cost.
(v) Ensure that depreciation is being provided with reference to distance in kilometres covered by the vehicle as against the mileage which it is expected to run in the lifetime.
(vi) Verify whether the motor vehicles have been properly shown under fixed assets in the balance sheet.

### 6.6.2 Verification and Valuation of Intangible Assets

An Intangible Asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion pictures films, customer loyalty, market share and marketing rights, etc. For valuation of Intangible Assets, the auditor has to examine whether the provision under Ind AS-38 have been followed.

Note 6(J) of Part I of Schedule III to the Companies Act, 2013 requires that the company shall disclose "Intangible Assets" in notes to accounts as follows:

(J) Intangible Assets: Classification of intangible assets shall be given as–

(a) Goodwill
(b) Brands/trademarks
(c) Computer software
(d) Mastheads and publishing titles

(e) Mining rights
(f) Copyrights, and patents and other intellectual property rights, services and operating rights
(g) Recipes, formulas, models, designs and prototypes
(h) Licenses and franchise
(i) Others (specify nature)

### A. Goodwill

Goodwill arises from business connections, trade name or reputation of an enterprise. It may be generated either on acquisition or is internally generated. Internally generated goodwill is not to be recognised as an asset, as it is not an identifiable resource controlled by the enterprise that can be measure reliably at cost. Goodwill should be recorded in the books, only when some consideration in money or money worth has been paid for it. Regarding valuation of goodwill, an appropriate method is to be adopted to write the cost down out of the available profits and in this way, it should be ensured that the capital of the business is represented by tangible assets only.

#### *Verification*

As it is not possible to verify goodwill physically, hence verification of goodwill means proper checking of accounting entries passed for it.

The following points are to be noted for verification of goodwill:

(i) Ensure that no goodwill is recorded, if no consideration has been paid. Goodwill has been recorded in the books only when some consideration in money or moneys has been paid for.
(ii) Goodwill is equal to purchase consideration *less* fair value of net assets acquired. To verify this goodwill, the auditor should refer to vendor's agreement, minutes of the meetings of board of directors, etc.
(iii) See that goodwill has not been shown in the company's books by writing up the value of its assets, on revaluation, or by writing back the amount of goodwill earlier written off.
(iv) Ensure that the goodwill not yet written off has been properly disclosed as per Schedule III requirements.
(v) See that the goodwill is being amortised as per financial prudence over a reasonable period.

#### *Valuation*

(i) As per the current norms, goodwill should be written off over a ten-year period and be shown at cost less accumulate amortisation.
(ii) The auditor should verify that goodwill appearing in the balance sheet has not been shown in excess of its cost price.
(iii) In case a firm is not earning above normal profits, the auditor should suggest for writing it off.

### B. Patent

A patent is an exclusive right granted by the Government to the manufacturer to dispose of or otherwise benefit from the result of the invention of a production process. It is an official document, which secures to an investor exclusive right to make, use and sell his invention.

***Verification***

(i) The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent.
(ii) If it has been purchased, the agreement surrendering it in favour of the client should be examined.
(iii) The document of the patent should be physically verified by the auditor and it should be seen that it has been duly registered.
(iv) The auditor should check the patent register in order to verify that it has been properly included therein.
(v) He has to verify that renewal fees have been paid on due dates by being charged to revenue and to the patent account.
(vi) The last renewal receipt should be examined to ascertain that the patent has not lapsed.
(vii) If a number of patents are held, a schedule thereof should be obtained.

***Valuation***

(i) The auditor should examine the patent to ensure that the company concerned is registered as the owner of the patent.
(ii) The auditor should ensure that patents are being shown at cost less amortisation charges.
(iii) Cost of the patent is the acquisition cost, which may be the purchase cost or the invention cost. Also the cost of registration of patent should be included in the valuation, while the renewal fees should be charged off to revenue.
(iv) If the patent has been developed by the client in house, all development expenses, legal charges, including registration fees and other direct costs incurred in creating it, should be capitalised.
(v) The cost of patent should be written off over the legal term of its validity or over its useful commercial life, whichever is shorter.

### C. Copyright

Copyright is the exclusive legal right to produce or reproduce and to sale the printed or some otherwise produced writings, drawings, musical composition, maps, works of arts, etc. It is the legal protection provided to an author, painter, composer, etc. by which the reproduction of his/her works by others is restricted.

***Verification***

(i) The existence of a copyright is verified by an inspection of the certificate as regards grant of the copyright.

(ii) Copyright is generally purchased. If it is purchased, the agreement surrendering the copyright in favour of the client and other supporting documents should be examined.

(iii) It must also be verified that the rights are alive and legally enforceable.

(iv) If there are a large number of copyrights, the auditor should obtain a 'schedule of copyrights' duly signed by a responsible official of the client and verify their existence.

(v) The auditor should verify that renewal fees have been paid and charged to revenue. In each case, the last renewal receipt should be examined to ascertain that the copyright has not expired.

#### *Valuation*

(i) Copyrights are generally valued at cost less amortisation charges till the date of verification.

(ii) For the purchased copyright, the cost includes purchase price and registration charges.

(iii) In case the copyright has been developed by the client, the cost should include cost of developing outlays, design costs and other associated direct cost.

(iv) The auditor should confirm that the legal life of the copyright has not expired.

(v) The cost of copyrights should be amortised over the period of legal validity or useful commercial life, whichever is shorter.

### D. Trademark

A trademark is a distinctive sign, symbol, design or brand name established to enable the customer to identify the product easily. It helps the purchaser to distinguish the product from similar goods available in the market.

#### *Verification*

(i) The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademarks.

(ii) The auditor should examine the certificate of registration issued by the office of the Registrar of Trademark to verify it is the property of the client.

(iii) For the purchased trademark, the agreement of surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable.

(iv) The auditor should obtain a schedule of trademarks and verify that renewal fees have been paid and charged to revenue.

(v) The last renewal receipt should be examined to ascertain that the trade mark has not lapsed.

#### *Valuation*

(i) Trademarks are generally valued at cost less amortisation charges till the date of verification.

(ii) If the trademark is purchased, the purchase price plus registration charges to be considered as the value of the trademark.

(iii) The auditor should examine that trademarks are properly valued and shown in the balance sheet.

(iv) The auditor should ensure that all expenses incurred in the acquisition of the trademark has been treated as capital expenditure, any renewal fees paid has been treated as revenue expenditure.

(v) If it has been developed by the client, the cost should include cost of developing outlays, design costs and other associated direct cost.

(vi) The cost of trademarks should be amortised over the period of legal validity or useful commercial life, whichever is shorter.

### 6.6.3 Verification and Valuation of Investments

Investments are the assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing enterprise. An investment constitutes a significant portion of the total assets. An investment may be represented by government securities, shares, debentures, etc. The auditor should check whether the provision of Ind AS-40 have been followed for valuation of Investment.

For verifying and valuing of investments, the auditor should aim at collecting sufficient audit evidence in order to assure himself about the existence, ownership, valuation and possession of investment in favour of the client.

***Verification***

The following procedures should be adopted for verifying the investments:

(i) The auditor should examine whether the investments made are within the authority of the entity.

(ii) He should obtain the investment register or schedule of securities containing the information of date of purchase, face value, book value, market value, rate of interest, date of payment of interest, date around which dividend is normally declared, etc.

(iii) Securities and shares purchased and sold during the year should also be considered while doing the audit work.

(iv) The balance of the register/schedule to be compared with the closing balance in the control account in the general ledger for cross verification.

(v) The auditor himself should also be satisfied that the transactions for the purchase/sale of investments are supported by due authority and documentation.

(vi) Check the adjustment made in the cost of acquisition or sales value of the security in case of ex-dividend/interest/right/bonus or in case of cum-dividend/interest/right/bonus purchase or sales.

(vii) The acquisition/disposal of investments should be verified with reference to the brokers' contract note, bill of costs, etc.

(viii) The auditor should verify the certificates corresponding to the investment physically on the last date of the accounting year.

(ix) In case investments are not held by the entity in its own custody, then a certificate should be obtained from the relevant authority.

(x) If the certificates are hold otherwise than in the name of the entity, the reasons must be justified.

(xi) If a company other than an investment or banking company have sold the assets of the company as represented by shares and debentures (investment) at a price less than the at which they were purchased by the company, the relevant provisions of Section 143(1) of the Companies Act, 2013 should be verified by the auditor.

(xii) The auditor should see title deeds of immovable properties and see that the same have been properly classified.

***Valuation***

(i) For determining of cost of investments and classifying investments into long-term investments and current investments, the auditor should compare valuation practices against those prescribed by recognised accounting principles.

(ii) Examine whether investments have been disclosed in the balance sheet according to recognised accounting principles and relevant statutory requirements, if any.

(iii) The auditor should examine whether in computing the cost of investment, the expenditure incurred on account of transfer fees, stamp duty, etc. is included in the cost of investments.

### 6.6.4 Verification and Valuation of Current Assets

#### A. Inventories/Stock in Trade

The responsibility for properly determining the quantity and value of inventories rests with the management of the entity. The management satisfies this responsibility by carrying out appropriate procedures which will include verification of all items of inventory at least once in every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. The guideline of Ind AS-2 to be taken into consideration while verifying and valuation of Inventories. Verification of inventories may be carried out by employing the following procedures:

(i) Examination of records

(ii) Attendance at inventory taking

(iii) Obtaining confirmations from third parties

(iv) Examination of valuations and disclosure

(v) Analytical review procedures

Notes 6(O) of Part I of Schedule III of the Companies Act, 2013 requires that a company shall disclose "Inventories" in notes to accounts as follows:

(O) Inventories:

(i) Inventories shall be classified as–

(a) Raw materials
(b) Work-in-progress
(c) Finished goods
(d) Stock in trade (in respect of goods acquired for trading)
(e) Stores and spares
(f) Loose goods
(g) Others (specify nature)

(ii) Goods in transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

***Verification***

(i) The auditor should obtain the detailed inventory records namely stores/inventory ledgers containing the major item such as receipts, issues and balances.
(ii) The auditor should examine these records with reference to the relevant basic documents such as goods received notes, inspection reports, material issue notes, bin cards, etc.
(iii) Observe physical count of inventory.
(iv) Inspect count instruction given to the staff of the management.
(v) Review the procedures to account for movement of inventories.
(vi) Review cutoff procedures.
(vii) Review procedures for identifying defective, damaged, obsolete, excess or slow moving items of inventory.
(viii) Inspect original verification sheets for inventories, trace them to the final summary of inventories and subsequently to book stocks. Discrepancies should be investigated into and adjustments be made.
(ix) Enquire about stocks held by third parties. Obtain direct confirmation, if necessary.
(x) Enquire about liens.

***Valuation***

(i) The auditor should ensure that inventory has been valued on the basis of corresponding accounting standard and norms.
(ii) Inspect supporting records relating to unit cost data.
(iii) Examine treatment of overheads.
(iv) Examine evidence in support of assessment of net realisable value.
(v) Carefully ascertain the stage of completion of work in progress.
(vi) Examine disclosure relating to inventory.

### B. Physical Attendance by Auditor During Inventory Taking

Physical verification of inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, it may be appropriate for the auditor to attend the inventory taking. The extent of auditor's attendance at inventory taking would depend upon his assessment of the efficacy of relevant internal control procedures, and the results of his examination of the inventory records maintained by the entity and of the analytical review procedures.

According to SA-501 'Audit Evidence–Specific Considerations for Selected Items', the management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

Attendance at physical inventory counting involves:

(i) Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts.

(ii) Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count, and

(iii) Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

Observing the performance of management's count procedures, for example, those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cut off information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspecting inventory when attending physical counting assists the auditor ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory. Performing test counts, for example, by tracing items selected from management's count records, provides audit evidence about the completeness and the accuracy of those records.

In addition to recording the auditor's test counts, obtaining copies of the management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

### C. Trade Receivable/Sundry Debtors

A receivable shall be classified as a trade receivable, if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business. The term trade

receivable suggests particularly the amount recoverable from customers, but in practice, it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

Note 6(P) of Part I of Schedule III to the Companies Act, 2013 requires a company shall disclose "Trade Receivable" in notes to accounts as follows:

(P) Trade Receivable:

(i) Aggregate amount of trade receivable outstanding for a period exceeding six months from the date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

  (a) Secured, considered good
  (b) Unsecured, considered good
  (c) Doubtful

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

***Verification***

Verification of trade receivables may be carried out by employing the following procedures:

(a) Examination of records
(b) Direct confirmation procedure (also known as circularisation procedure)
(c) Analytical review procedures

However, the nature, timing and extent of audit procedures to be performed are a matter of professional judgment of the auditor.

The general procedures for verification of inventories/stock in trade are as under:

(i) The auditor should obtain a schedule of debtors duly signed by a responsible officer and examine it with reference to individual debtors' accounts.

(ii) The auditor should carry out an examination of the relevant records himself about the validity, accuracy and recoverability of the trade receivables balances.

(iii) The provision for bad and doubtful debts is to be recomputed and compared it with past period.

(iv) The auditor should check the agreement of balances as shown in the schedules of trade receivable with those in the ledger accounts.

(v) Inspect relevant correspondence such as court order declaring insolvency of a debtor. Correspondence between the client and his lawyer for bad debts written off.

(vi) Verification of subsequent realisations is a widely used procedure, even in cases where direct confirmation procedure is followed.

(vii) While examining the schedules of trade receivables with reference to the trade receivables' ledger accounts, the auditor should pay special attention to the following aspects:

- Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.
- Where the amount outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.
- Whether transfer from one account to another are properly evidenced.

(viii) Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorisation should be inspected.

***Valuation***

(i) The auditor should examine to ascertain whether debtors have been properly classified and disclosed in balance sheet in accordance with recognised accounting principles and statutory requirements, if any.

(ii) He should check whether the debtor's ledger that are representing the value of book debts are supported by sales documents.

(iii) The auditor should call for the lists of book debts and debts written off and arrive at the conclusion about adequacy of write off and provision for doubtful debts.

### D. Cash at Bank

Note 6(Q) of Part I of Schedule III to the Companies Act, 2013 requires company shall disclose "Cash and cash equivalents" in notes to accounts as follows:

(Q) Cash and Cash Equivalents:

(i) Cash and Cash Equivalents shall be classified as:

(a) Balance in Bank
(b) Cheques, Drafts on Hands
(c) Cash on Hands
(d) Others (specifying nature)

(ii) Earmarked balance with banks shall be separately stated.

(iii) Balance with bank to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than twelve months maturity shall be disclosed separately.

***Verification***

(i) The auditor should confirm the cash at bank lying in all types of account of the company directly with the bank. The confirmation request must be signed by an appropriate representative of the client.

(ii) He should examine the bank reconciliation statement prepared as on the last day of the year.

(iii) He should also obtain separate certificate for Fixed Deposit Account, Current Account and Savings Bank Account from different banks to confirm total deposits in different banks.

(iv) While examining the bank statements, care should be taken to ensure that the post dated cheques issued/received have not been accounted for as payments/receipts of the period under audit.

(v) If there is any remittance in transit that should be verified with reference to their credit in the bank account in the subsequent period.

(vi) The auditor should also examine the funds lying in the bank accounts in foreign countries, if any.

(vii) Cash at bank should be shown in the financial statements as per the recognised accounting principles and statutory requirements, if any.

(viii) Ensure dishonored cheques are not included in the balance sheet.

***Valuation***

(i) Cash at bank should be shown in the financial statements as per the recognised accounting principles and statutory requirements, if any.

(ii) Examine whether proper disclosures have been made of balances or deposits with specific charge or restrictions, for example, amounts lying in banks which are under liquidation, amounts lying in foreign banks which are subject to exchange control restrictions.

(iii) In order to ascertain the current position with regard to cheques issued, but not yet presented or cheques deposited but not collected, the auditor should confirm through cash book and pass book figures.

(iv) The auditor should also ensure that the bank balances are properly disclosed in the balance sheet according to Schedule III of the Companies Act, 2013.

**E. Cash in Hand**

The following Cash Balances are included under the head of 'Cash in hand' in a balance sheet:

(i) Cash balance in hand

(ii) Petty cash balance in hand

(iii) Balance of stamps in hand

(iv) Cash in transit

(v) Cash at branches

(vi) Cash with agents

***Verification***

(i) The auditor should physically count the cash at the close of business on the last day of the fiscal period under audit or a date close to it.

(ii) Surprise checks of cash may be conducted by the auditor during the year, particularly, when the entity is consistently maintaining unduly large cash balances.

(iii) The auditor should obtain a certificate from the accountant about the actual cash balance in hand on the date of the balance sheet.

(iv) If possible, all cash balances such as petty cash, balance of staff societies, etc., should be verified simultaneously and count should always be made in the presence of the custodian of each of the funds.

(v) Carry out surprise verification of cash during the year. Ensure that there is no difference between actual cash in hand and balance as per books. If it exists, call for an explanation from the management.

(vi) As far as cash in transit is concerned, the auditor should verify this balance with the help of proper documentary evidences and correspondence.

***Valuation***

(i) The auditor should ascertain whether cash has been disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

(ii) Payment system of the company to be checked and the safety arrangements provided for the protection of cash balance are to be examined.

(iii) He should ensure that temporary advances are not included in cash in hand and if postage and revenue stamps exist in a substantial number, they should be shown separately and not included in cash in hand.

(iv) The auditor should call for explanation if cash-in-hand is not matched with the balance as shown in the books.

### 6.6.5 Verification and Valuation of Other Assets

In this section, verification and valuation of other assets are discussed.

#### A. Preliminary Expenses

Preliminary expenses are the expenditure incurred in relation to the creation, formation and floating of a company. It consists of stamp duties, registration fees, legal taxes, consultation fees, expenses of printing of memorandum of articles, etc.

***Verification***

(i) The auditor should obtain board's minutes book containing the resolution to verify whether the expenses have been approved by competent authority in formation of the company.

(ii) Supporting papers and vouchers, contracts, agreements, etc. are to be examined to support the promoters' claims. He also check bills and receipts, the memorandum and articles of association, share certificates, etc.

(iii) Check receipts for the registration fee paid for registration of the company.

(iv) Verify rates of stamp required to be affixed on the memorandum and articles of association.

(v) Check that no expenses other than those what constitutes preliminary expenses are booked under this head, e.g., underwriting commission and brokerage paid.

(vi) The auditor should examine the contracts relating to preliminary expenses. If preliminary expenses incurred by the promoters have been reimbursed to them by the company, the resolution of the Board and the power in the Articles of Association to make such payment should be seen.

**B. Contingent Assets**

Contingent asset may be defined as "an asset in which the possibility of an economic benefit depends solely upon future events that can't be controlled by the company." Contingent assets are the possible asset that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

The contingent assets are those which may arise on the happening of an uncertain event. As a general practice, contingent assets are not recorded in the balance sheet because that would imply taking credit for revenue which has not accrued. Contingent assets should not be recognised, but should be disclosed where an inflow of economic benefits is probable. When the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

As a general practice, contingent assets are not recorded in the balance sheet because that would imply taking credit for revenue which has not accrued. However, if contingent assets have a significant value, it may be advisable to disclose such assets in a note to the balance sheet. Some of the examples are given as under:

(i) Uncalled share capital of a company.

(ii) Legal action taken for valuation of copyright.

(iii) An option to apply for another company's shares.

(iv) Claim for money from a previous endorser of a bill receivable which had been discounted, but which might be dishonoured.

***Verification***

(i) The auditor has to ensure that no contingent asset has been included in accounts.

(ii) As regards valuation of contingent assets, it may be noted that ordinarily no valuation would be required. However, if such assets are disclosed by way of a note, a proper valuation based on the related contract would be made.

(iii) The auditor should make a list of all future events that affect the future economic benefit. He should map potential economic benefit with all the future events. It can be a one-time payment or stream of payments.

## 6.7 VERIFICATION AND VALUATION OF LIABILITIES

Liabilities are the financial obligations of an enterprise. The auditor has to satisfy himself that all liabilities whether existing or contingent have been properly determined and disclosed in the balance sheet. One important feature of liability is that these are represented only by documentary evidence which originates mostly from third parties in their dealing with entity.

### 6.7.1 Verification of Specific Liabilities

#### A. Share Capital

Excepting a private company, every other company issue a prospectus, this may be in the abridged form, or a statement in lieu of prospectus, before it proceeds to allotment, share capital. The audit of share capital is necessary both on incorporation and afterwards whenever the directors decide to increase the subscribed share capital.

#### B. Nominal or Authorised or Registered Capital

This form of capital has been defined in Section 2(8) of the Companies Act, 2013. Authorised Capital or Nominal Capital means such capital as is authorised by the memorandum of a company to be the maximum amount of share capital of the company.

***Verification***

The authorised capital may be verified with reference to the amount shown in the Memorandum of Association. Previous year audited balance sheet may also be seen.

#### C. Issued Capital

Section 2(50) of the Companies Act, 2013 defines Issued Capital which means such capital as the company issues from time to time for subscription. It is that part of authorised capital which is offered by the company for subscription. Schedule III of the Companies Act, 2013, makes it obligatory for a company to disclose its issued capital in the balance sheet.

***Verification***

(i) Verify the amount of issued capital with reference to last year audited balance sheet. Also, see whether the Central Government has issued any notification for conversion of debenture or loan into equity share under Section 62(4).

(ii) Study the conditions of issue contained in the Memorandum and Articles of Association, Prospectus or Statement in lieu of Prospectus, shelf prospectus, red-herring prospectus and information memorandum, as the case may be, and see that all of them have fully been complied with.

(iii) Verify that the first allotment was not made until the amount of minimum subscription stated in the Prospectus had been subscribed and until then the amount received was kept deposited in a scheduled bank as required by Section 39 of the Act.

(iv) Confirm that the brokerage and underwriting commission was paid only at the rates authorised by the Prospectus or the Articles of Association, having regard to the provisions contained in Section 40 of the Act.

(v) Ensure that legal requirements as laid down in Section 62 (dealing with right shares) have been complied with.

(vi) Ensure that the company intending to offer shares to the public for subscription by the issue of a Prospectus has, before such issue, made an application to one or more recognised stock exchanges for permission for the shared intending to be so offered within the stock exchange or each stock exchange as required by the Companies Act, 2013.

(vii) Confirm that the guidelines issued by the Securities and Exchange Board of India (SEBI) have been followed. Compliance reports submitted by lead managers and reports submitted to SEBI may be examined in this regard.

(viii) Verify compliance with legal provision relating to issue of shares at premium (Section 52), Prohibition on issue of shares at discount (Section 53), and issue of sweat equity shares (Section 54).

### D. Shares Issued for Cash

Usually, there are three stages in the issue of shares for cash, viz,

(i) Receipt of applications for shares along with application money

(ii) Allotment of shares and receipt of allotment money

(iii) Making calls and receipt of call money

#### *Verification*

The programme of work to be carried out in respect of each of the above mentioned three stages is stated below:

#### *Applications*

The auditor should verify the amount received along with the applications for shares in the following manner:

(i) Check entries in the Application and Allotment Book (or Sheets) with the original applications.

(ii) Check entries in the Application and the Allotment Book as regards deposits of money, received with the applications, with those in the Cash Book.

(iii) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret.

(iv) Check the totals columns in the Application and Allotment Book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.

***Allotment***

(i) Examine Director's Minutes Book to verify approval of allotments.
(ii) Compare copies of letters of allotment with entries in the Application and Allotment Book.
(iii) Trace entries in the Cash Book into the Application and Allotment Book for the verification of amount collected on allotment.
(iv) Trace the amount collected on application as well as those on allotment from the Application and Allotment Book into the Share Register.
(v) Check whether the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on such application have been received by the company.
(vi) Check totals of amount payable on allotment and verify the journal entry debiting Share Allotment Account and crediting Share Capital Account.

***Calls***

(i) Examine the Director's resolution making the call.
(ii) Vouch amounts received with the counterfoils of receipts.
(iii) Trace posting of the amount received from the Calls Book (for calls due) and the Cash Book (for calls collected) into the Share Register.
(iv) Verify the journal entry, debiting the Call Account and crediting Share Capital with totals of the amount due.
(v) Note the calls in arrears.

The following areas should be **verified in general** by the auditor for verification of shares issued for cash:

(i) Ascertain that the nominal value of shares allotted, does not exceed the authorised and issued capital and that allotments were made in accordance with conditions contained in the Prospectus.
(ii) See the returns of allotment have been filed with the Registrar of Companies.
(iii) Extract balances of shareholders' accounts contained in the Share Register and tally their total with the balance in the Share Capital Account.
(iv) If the issue was underwritten, examine the contract with the underwriters to ensure that all obligations under the contracts have been fully satisfied.
(v) Vouch payment of commission and brokerage.
(vi) See that the company has delivered share certificated within three months after the allotment on any of its shares in accordance with the procedure laid down under Section 53.

### E. Issue of Sweat Equity Shares

As per Section 53 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares'. Sweat equity shares 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.

***Verification***

The auditor may see that the sweat equity shares issued by the company are of a class of shares already issued and following conditions are fulfilled:

(i) The issue is authorised by a special resolution passed by the company,

(ii) The resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued,

(iii) Not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business, and

(iv) Where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

**F. Loans and Borrowings**

***Verification***

(i) The auditor should examine whether the loans obtained are within the borrowing powers of the entity.

(ii) He should check relevant records and documentation supporting the transactions.

(iii) Confirm loans and borrowings outstanding and interest payable on them directly with the lender.

(iv) In case the enterprise has acquired assets under hire purchase agreements, ensure that future installments have been shown as secured loans.

(v) Examine reconciliation of the books balances with statements of lenders.

(vi) Examine documents, if any, evidencing any charge created in respect of loans and advances. In particular, examine compliance with the requirements of the applicable statute regarding creation and registration of charges.

(vii) Where the entity has accepted deposits, examine whether the directives issues by the Reserve Bank of India or other appropriate and relevant statutory requirements, if any, have been duly complied with.

***Valuation***

(i) The auditor should examine whether liabilities are classified and disclosed in the balance sheet in accordance with recognised accounting principles and relevant statutory requirements, if any.

(ii) Examine whether instalments of long-term loans falling due within next twelve months have been disclosed in the balance sheet as a footnote or in parentheses.

(iii) Where the market value of an asset offered as a security against loan has fallen below the amount of loan outstanding, ensure that the loan is classified as secured only to the extent of market value of security.

(iv) Ensure that the assets hypothecated as securities in case of a company are duly registered with Registrar of Companies and are recorded in the register of charges as required under the Companies Act, 2013.

### G. Borrowings from a Bank

Borrowings from a bank may be either in the form of overdraft limits, or short term or medium term or long term loans. The audit procedures which an auditor may adopt are outlined below:

***Verification***

(i) Ensure that balance as per books of the client and the bank statement tally. In case of difference between the two amounts, reconciliation statement prepared by the client should account for reasons.

(ii) Examine whether borrowings from the bank have been duly authorised.

(iii) Examine documents to ensure that statutory requirements, if any, with regards to creation and registration of charges, have been met.

(iv) Examine the loan agreement and ensure that the terms therein have been duly complied with.

(v) Ascertain the purpose for which loan has been raised and examine whether the end use of the funds have been accordingly made.

### H. Sundry Creditors

***Verification***

(i) The auditor should obtain the schedule of creditors and examine it with reference to individual creditors' accounts.

(ii) He should inspect documents underlying purchases such as invoices, receiving reports, etc., and verify individual creditors' accounts balance against these documents.

(iii) He should also examine the invoices as sent by the suppliers. He should carry out test checking of purchases made during the year, particularly those made at the close of the year.

(iv) If the client maintains provision in respect of discount on creditors, he should check the same with reference to the creditors account.

(v) Vouch subsequent payments to trade creditors.

(vi) The adequacy of cutoff procedure adopted by the business for separating credits and debits to creditor accounts for the year under audit and subsequent year should be checked carefully to know the unrecorded liabilities.

(vii) Communicate directly with the creditor so as to obtain confirmations of the amount due from them.

*Valuation*

Ensure that the creditors have been disclosed properly in the financial statements as per the recognised accounting principles and relevant statutory requirements, if any.

**I. Contingent Liabilities**

Contingent liability is

(i) a possible obligation that arises from past events and the existence of which will be formed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise, or

(ii) a present obligation that arises from past events but is not recognised because

  (a) it is not probable that an outflow of resource embodying economic benefits will be required to settle the obligation, or

  (b) a reliable estimate of the amount of the obligation cannot be made.

As per the above definition, to be called contingent liability, the following condition must be fulfilled:

(a) Possible obligation as a result of past event.

(b) Existence of which will be confirmed only by the occurrence or non-occurrence of future event.

(c) Future event not wholly within the control of the enterprise.

Examples of contingent liabilities are:

(i) disputed liability on account of income tax

(ii) sales tax disputed

(iii) discounting of bills receivables

(iv) pending suits for damages or compensation

(v) guarantee given by the bank on behalf of the company.

The Schedule III to the Companies Act, 2013 requires disclosure of following liabilities/ commitments, to the extent not provided for, by way of a note:

(i) Classification of contingent liabilities:

- Claims against the company not acknowledged as debts
- Guarantees
- Other money for which the company is contingently liable

(ii) Classification of commitments into

- Estimated amount of contracts remaining to be executed on capital account and not provided for
  - Uncalled liability on shares and other investments partly paid
  - Other commitments (specifying nature)

***Verification***

(i) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body
(ii) Review of contracts, agreements and arrangements
(iii) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.
(iv) Review of terms and conditions of grants and subsidies availed under various schemes
(v) Review of records relating to contingent liabilities maintained by the entity
(vi) Enquiry of, and discussions with, the management and senior officials of the entity
(vii) Representations from the management
(viii) The auditor should verify that contingent liabilities do not include any items which require an adjustment of relevant assets or liabilities.

## SUMMARY

- Verification of assets is a process by which the auditor substantiates the accuracy of the right-hand side of the Balance Sheet, and must be considered as having three distinct objects: (a) the verification of the existence of assets, (b) the valuation of assets and (c) the authority of their acquisition.
- Verification of assets and liabilities is undertaken with the objectives to show correct valuation of assets and liabilities, to know whether the balance sheet exhibits a true and fair view of the state of affairs of the business, to find out the ownership, possession and title of the assets, etc.
- Window dressing is a technique used by companies and financial managers to manipulate financial statements and reports to show more favorable results for a period. Window dressing is usually done to mislead investors.
- The auditor should ensure that no attempts have been made by the client to adopt window dressing.
- Sometimes verification is confused with vouching but they differ from each other on the nature and depth of the examination involved.
- Vouching goes to prove the arithmetical accuracy and the genuineness of the transactions, whereas verification goes to enquire into the value, ownership, existence and possession of assets and also to confirm whether they are free from any mortgage or charge or not.
- Valuation of assets means the examination of the accuracy and propriety of the valuation of those assets, which are shown in the Balance Sheet of any concern at the end of the financial year.
- Valuation of assets is a part and parcel of verification. Without proper valuation of assets, verification is not possible. Verification includes, apart from valuation, the examination of ownership right, the existence of the asset in the business and its freeness from any sort of charge or mortgage.

- For verifying the Property, Plant and Equipment, the auditor should, normally, verify the records with reference to the documentary evidence and by evaluation of internal controls. Physical verification of PPE is primarily the responsibility of the management.
- For verifying the specific assets, the auditor should verify the title deed to see whether the client holds the title on the Balance Sheet date. If the property has been mortgaged, the title deed will be in the possession of the mortgagee from whom a certificate should be obtained.
- For valuation of specific assets, the auditor should examine the correctness of the depreciation, proper presentation in the balance sheet as per Schedule III of the Companies Act, 2013, provision of corresponding Ind AS if any, etc.

## EXERCISE

### A. Short Answer Type Questions (2–4 marks)

1. Distinguish between vouching and verification of assets.
2. Do you think that verification of Assets and Liabilities is necessary when vouching has been done properly?
3. What are the basis for valuation of Fixed Assets and Floating Assets to be shown in the balance sheet?
4. What are the points to be enquired into by an auditor for verification of Liabilities?
5. What is meant by verification of assets for balance sheet purposes?
6. Verification forms an important part of the whole system of audit—Discuss.
7. Intangible Assets are not always Fictitious Assets—Illustrate. [*C.U. B.Com(H), 2000*]
8. What is the importance of valuation of Assets? [*C.U. B.Com(H), 2001*]
9. What do you mean by issue of debentures as collateral security? What are the duties of an auditor in this regard? [*C.U. B.Com(H), 2002*]
10. Explain the term 'Contingent Asset' and its treatment in the books of accounts. [*C.U. B.Com(H), 2004*]
11. What are the duties of an auditor regarding verifications of debtors? [*C.U. B.Com(H), 2005*]
12. Distinguish between verification and valuation of assets. [*C.U. B.Com(H), 2006*]
13. Explain the concept of 'contingent liability' with examples. [*C.U. B.Com(H), 2007*]
14. Distinguish between vouching and verification. [*C.U. B.Com(H), 2007*]
15. It is not part of an auditors' duty to take stock—Discuss. Briefly with reference to case laws. [*C.U. B.Com(H), 2008*]

16. What do you mean by Contingent Liabilities? How is it disclosed in financial statements? [*C.U. B.Com(H), 2008*]
17. Distinguish between Vouching and Verification.
18. 'Verification includes valuation' - Comment.
19. What do you meant by Fictitious Assets? Give examples.
20. Write a short note on 'Window dressing of Balance sheet'.
21. What are challanges faced by an auditor while valuation of assets and liabilities?
22. Write a short note on valuation of 'land and building'.

## B. Essay Type Questions (8–10 marks)

1. Discuss the principles of verification of the following Assets:
   (a) Raw Materials
   (b) Land
2. All auditors are not valuer. And an auditor is intimately connected with value—State the nature of duties of an auditor in regard to valuation of assets and liabilities.
3. What do you mean by the term 'Contingent Assets'? Give few examples of this type of assets. What should be the duty of an auditor in this regard?
4. Discuss the problem in the valuation and verification of assets.
5. How would you as an auditor verify the following?
   (a) Provision for taxation
   (b) Leasehold property
   (c) Contingent liabilities
6. What is Goodwill? As an auditor how would you ascertain that an amount paid for goodwill is justified?
7. How an auditor should verify the following?
   (a) Preliminary expenses
   (b) Machineries purchased on hire purchase system
8. How would you verify the following items?
   (a) Work in progress
   (b) Investment
9. How and in what way does verification of assets and liabilities differ from vouching? How would you verify the following?
   (a) Freehold Property
   (b) Loan and Advance
   (c) Copyright
10. How an auditor should verify the following? [*C.U. B.Com(H), 1997*]
    (a) Preliminary expenses
    (b) Patterns and design

11. It has been stated that the valuation of investment for the balance sheet purposed depends largely upon the object for which investments are held—Discuss the statement.

    [*C.U. B.Com(H), 1998*]

12. 'It has been said that it is no part of an auditor's duty to take stock.' What will be your opinion as an auditor in this regard? Discuss referring to relevant legal decisions.

    [*C.U. B.Com(H), 1999*]

13. Verification includes Valuation—Comment. How do you verify the following assets and liabilities?

    (a) Debtors

    (b) Secured Loan [*C.U. B.Com(H), 2000*]

14. It is often said that it is no part of an auditor's duty to take stock. What would be your opinion in this respect as an auditor? [*C.U. B.Com(H), 2003*]

15. Auditor is not a valuer. An auditor is intimately connected with values—State the nature of duties of an auditor in regard to valuation of assets and liabilities in the light of above two statements. [*C.U. B.Com(H), 2004*]

16. Why verification is necessary even though vouching has been done? Set out the steps you would take as an auditor while verifying the stock and investment as shown in the balance sheet of a company. [*C.U. B.Com(H), 2005*]

17. How will you verify the following items as an auditor (*any three*)?

    [*C.U. B.Com(H)*, 2007]

    (a) Plant and machinery
    (b) Goodwill
    (c) Investments
    (d) Debtors
    (e) Copyright

18. How will you verify the following items as an auditor (*any three*)?

    [*C.U. B.Com(H), 2008*]

    (a) Patents
    (b) Secured loan from bank
    (c) Contingent assets
    (d) Loans and advances
    (e) Preliminary expenses

19. How do you verify the following assets (*any three*)? [*C.U. B.Com(H), 2012*]

    (a) Debtors
    (b) Goodwill
    (c) Investment
    (d) Inventories

20. How do you verify the following items (*any three*)?
    (a) Patent [*C.U. B.Com(H), 2012, 2014*]
    (b) Contingent assets
    (c) Share capital
    (d) Plant and machinery [*C.U. B.Com(H), 2012, 2014*]
    (e) Secure loan
21. How would you verify the advances? [*C.U. B.Com(H), 2012*]
22. How would you verify the following (any three)? [*C.U. B.Com(H), 2011*]
    (a) Investment
    (b) Building
    (c) Goodwill
    (d) Contingent liabilities
    (e) Preliminary expenses
23. Is there any necessity of verification of assets and liabilities after proper vouching? Discuss with reasons. How do you vouch the following transactions?
    [*C.U. B.Com(H), 2013*]
    (a) Director's remuneration
    (b) Preliminary expenses
24. How do your verify the following items? [*C.U. B.Com(H), 2013*]
    (a) Goodwill or Investment
    (b) Freehold Land
25. (a) What do you mean by verification and valuation of assets?
    (b) Do you think that valuation is included in the task of verification?
    (c) Define the term contingent liability. Give two examples of it.
    [*C.U. B.Com(H), 2015*]
26. Explain the general principles of verification of assets. What are the objectives of verification of assets?
27. How will you verify the following items?
    (a) Sweat Equity Shares
    (b) Sundry creditors
    (c) Cash at bank
    (d) Inventories

# 7 CHAPTER
# COMPANY AUDIT

## CHAPTER OUTLINE

**7.1** Introduction
**7.2** Company Auditor
**7.3** Branch Audit
**7.4** Joint Audit
**7.5** Maintenance of Books of Accounts
**7.6** Related Party Disclosures
**7.7** Segment Reporting
**7.8** Divisible Profits and Dividends
**7.9** Depreciation
**7.10** Written Representation by Management
**7.11** Annual Report
**7.12** New Areas under Companies Act, 2013

## 7.1 INTRODUCTION

A company is a form of organisation which is created, maintained and even abolished through the application of law. In other words, every single event in a company is subject to certain legal provisions. Accordingly, auditing in a company is exclusively guided by the provisions of various acts, rules and other legal decisions. In this context, the following sources of legal provisions may be mentioned.

(i) Companies Act, 2013 (along with all relevant amendments)
(ii) Various Company Rules (along with all relevant amendments)
(iii) Relevant sections of The Chartered Accountants Act, 1949
(iv) Accounting Standards notified by the Ministry of Corporate Affairs
(v) Various Standards of Auditing issued by the Institute of Chartered Accountants of India

Our discussion in the rest of this chapter will be based on the above provisions exclusively.

## 7.2 COMPANY AUDITOR

A company is characterised by the separation of management and ownership. Though shareholders are the owners of company's assets, they do not actively take part in the management of the company. Company is rather managed by a group of managers who are entrusted with the proper utilisation of the resources of the company for the maximum benefit of its shareholders. Therefore, in this context, it is imperative that management's stewardship is properly vouched by an independent third party. This is why audit of books of accounts has been made mandatory in every company. At the same time, specific provisions covering all relevant aspects of audit and auditor have been incorporated to attain the highest possible standard.

### 7.2.1 Qualifications of a Company Auditor

Irrespective of the actual form, every company is required to undergo statutory audit by a qualified auditor. As per Section 141 of Companies Act, 2013, the following persons should be considered as qualified for this purpose.

(i) A person shall be eligible for appointment as an auditor of a company, only if he is a chartered accountant [Section 141(1)].
(ii) A firm can also be appointed by its firm name to be the auditor of a company if majority of partners practising in India are qualified for appointment as company auditor [Section 141(1)].
(iii) Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm [Section 141(2)].

**Note:** In this context, the meaning of the term 'chartered accountant' shall be interpreted based on the provisions of The Chartered Accountants Act, 1949 as follows.

(i) "Chartered Accountant" means a person who is a member of the Institute [Section 2].
(ii) A person will be a member of the Institute if his name appears in the Register of the Institute [Section 3].
(iii) The following persons shall be entitled to have his name entered in the Register [Section 4]:
    (a) any person who is a registered accountant or a holder of a restricted certificate at the commencement of this Act.
    (b) any person who has passed such examination and completed such training as may be prescribed for members of the Institute.
    (c) any person who has passed the examination for the Government Diploma in Accountancy or an examination recognised as equivalent thereto by the rules for the award of the Government Diploma in Accountancy before the commencement of this Act and fulfils such conditions as specified by the Central Government in this behalf.

(d) any person who, at the commencement of this Act, is engaged in the practice of accountancy in any State and fulfils such conditions as specified by the Central Government in this behalf.

(e) any person who has passed such other examination and completed such other training without India as is recognised by the Central Government or the Council as being equivalent to the examination and training prescribed for members of the Institute.

(f) any person domiciled in India, who at the commencement of this Act is studying for any foreign examination and is at the same time undergoing training, whether within or without India, have passed the examination or completes the training within five years after the commencement of this Act.

In order to become the member of the Institute, the aforesaid persons must reside in India or must be in practice in India. For any person outside India with all other requisite qualifications, the Central Government or the Institute may impose additional conditions. Moreover, any qualified persons will have to formally apply for the membership to the Institute with requisite fees. His name will be included in the Register only if the application is accepted.

### 7.2.2 Disqualification of a Company Auditor

As per Section 141(3), read with Rule 10 of Company (Audit and Auditor) Rule 2014, the following persons shall not be eligible for appointment as an auditor of a company:

(i) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(ii) an officer or employee of the company;

(iii) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(iv) a person who, or his relative or partner:

(a) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company, of face value not exceeding rupees one lakh;

(b) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh;

(c) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees one lakh;

(v) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;

**Note:** For this purpose, the term 'business relationship' shall be construed as any transaction entered into for a commercial purpose, except–

(a) commercial transaction which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Companies Act, 2013 or the Chartered Accountants Act, 1949 and the rules or regulations made under those Acts;

(b) commercial transactions which are in the ordinary course of business of the company at arm's length price–like sale of products or services to the auditor as customer.

(vi) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(vii) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(viii) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(ix) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in Section 144.

Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor [Section 141(4)].

**Note:** According to Section 144 of the Companies Act, 2013, an auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be. However, such services shall not include the following services, whether rendered directly or indirectly to the company or its holding company or subsidiary company.

(a) accounting and book keeping services;
(b) internal audit;
(c) de sign and implementation of any financial information system;
(d) actuarial services;
(e) investment advisory services;
(f) investment banking services;
(g) rendering of outsourced financial services;
(h) management services; and
(i) any other kind of services as may be prescribed:

Any auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

### 7.2.3 Appointment of a Company Auditor

Appointment of a statutory auditor in case of a company is governed by Section 139 of Companies Act, 2013.

**A. Appointment in Normal Course**

The provisions in this respect can be discussed under the following two broad categories:

**(i) Provisions Relating to Appointment of First Auditor**

**(a) In case of a company other than a Government company [Section 139(6)]**

- The first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within thirty days from the date of registration of the company.
- In the case of failure of the Board to appoint such auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting appoint such auditor.
- The auditor, so appointed, shall hold office till the conclusion of the first annual general meeting.

**(b) In case of a Government company [Section 139(7)]**

- In the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within sixty days from the date of registration of the company.
- In case the Comptroller and Auditor-General of India does not appoint such auditor within the aforesaid period, the Board of Directors of the company shall appoint such auditor within the next thirty days.
- Further, in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within sixty days at an extraordinary general meeting.
- The auditor, so appointed, shall hold office till the conclusion of the first annual general meeting.

**Note:** For the aforesaid purpose 'Government Company' shall mean a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government Company.

**(ii) Provisions Relating to Appointment of Subsequent Auditor**

**(a) In case of a company other than a Government company [Section 139(1), read with Rule 3 and 4 of Company (Audit and Auditors) Rule 2014]**

- Every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion

of its sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

- The company shall place the matter relating to such appointment for ratification by members at every annual general meeting till the sixth such meeting by way of passing of an ordinary resolution [Rule 3(7)].

  If the appointment is not ratified by the members of the company, the Board of Directors shall appoint another individual or firm as its auditor or auditors after following the procedure laid down in this behalf under the Act [Rule 3(7)].
- Before such appointment is made, the written consent of the auditor to such appointment and a certificate[1] from him or it that the appointment, if made, shall be in accordance with the conditions as prescribed, shall be obtained from the auditor. The certificate shall also indicate whether the auditor satisfies the criteria provided in Section 141.
- The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within fifteen days of the meeting in which the auditor is appointed in Form ADT-1 [Rule 4(2)].

**(b) In case of a Government company [Section 139(5)]**

- In the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year.
- The auditor, so appointed, shall hold office till the conclusion of the annual general meeting.

## B. Appointment in Case of Filling a Casual Vacancy [Section 139(8)]

**(i) In case of a company other than a company whose accounts are subject to audit by an auditor appointed by the CAG i.e. for Non-Government companies**

(a) Any casual vacancy will be filled by the Board of Directors within thirty days.

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[1] As per Rule 4(1) of CAAR 2014, the auditor appointed under Rule 3 shall submit a certificate that–

(a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Act, the Chartered Accountants Act, 1949 and the rules or regulations made thereunder;

(b) the proposed appointment is as per the term provided under the Act;

(c) the proposed appointment is within the limits laid down by or under the authority of the Act;

(d) the list of proceedings against the auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

(b) If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board.

(c) The auditor, so appointed, shall hold the office till the conclusion of the next annual general meeting.

**(ii) In case of a company whose accounts are subject to audit by an auditor appointed by the CAG i.e. for Government companies**

(a) Any casual vacancy will be filled by the Comptroller and Auditor-General of India within thirty days.

(b) In case the Comptroller and Auditor-General of India does not fill the vacancy within the aforesaid period, the Board of Directors shall fill the vacancy within next thirty days.

**Note:** Though not defined clearly, 'casual vacancy' for the aforesaid purpose usually implies cessation of service of an existing auditor due to his death, resignation, disqualification, etc.

**Note:** As per Section 140(2) of Companies Act, 2013, the auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed Form ADT – 3 (as per Rule 8 of CAAR 2014) with the company and the Registrar, indicating the reasons and other facts as may be relevant with regard to his resignation.

In case of companies referred to in sub-section (*5*) of Section 139, the auditor shall also file such statement with the Comptroller and Auditor-General of India.

### C. Re-appointment of Company Auditor [Section 139(9)]

A retiring auditor may be re-appointed at an annual general meeting, if—

(i) he is not disqualified for re-appointment;

(ii) he has not given the company a notice in writing of his unwillingness to be re-appointed; and

(iii) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

### D. Automatic Re-appointment of Company Auditor [Section 139(10)]

Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

### E. Recommendation of Audit Committee [Section 139(11)]

Where a company is required to constitute an Audit Committee under Section 177, all appointments, including the filling of a casual vacancy of an auditor shall be made after taking into account the recommendations of such committee.

### 7.2.4 Manner and Procedure for Selection of Auditors

Rule 3 of the Company (Audit and Auditor) Rules, 2014 prescribes the following procedures for selection of any auditor:

(i) In case of a company that is required to constitute an Audit Committee under Section 177, the Committee, and, in cases where such a Committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

The Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court [Rule 3(1)].

(ii) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit [Rule 3(2)].

(iii) Where a company is required to constitute the Audit Committee –

(a) The Committee shall recommend the name of an individual or a firm as auditor to the Board for consideration [Rule 3(3)].

(b) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting [Rule 3(4)].

(c) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the Committee for reconsideration citing reasons for such disagreement [Rule 3(5)].

(d) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting [Rule 3(6)].

(iv) Where a company is not required to constitute the Audit Committee, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment [Rule 3(3)].

### 7.2.5 Rotation of Company Auditor [Section 139(2) read with Rule 5 of CAAR 2014]

#### A. Applicability of Rotation

The provisions for rotation of auditors will be applicable to–

(i) All listed companies excluding one person companies and small companies.

(ii) All unlisted public companies having paid up share capital of rupees ten crore or more;

(iii) All private limited companies having paid up share capital of rupees twenty crore or more;

(iv) All other companies having public borrowings from financial institutions, banks or public deposits of rupees fifty crore or more.

**B. Manner of Rotation**

(i) No individual shall be appointed or reappointed as auditor for more than one term of five consecutive years.

(ii) No audit firm shall be appointed or reappointed as auditor for more than two terms of five consecutive years.

**C. Other Conditions**

(i) An individual auditor or an audit firm who/which has completed his/its term shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.

(ii) During the above cooling off period, even audit firm having one or more common partners with the firm which has completed the term, shall not be appointed as auditor.

(iii) Every company, existing on or before the commencement of this Act which is required to comply with provisions of Section 139(2), shall do so within three years from the date of commencement of this Act.

(iv) The above provisions shall not prejudice the right of the company to remove an auditor or the right of the auditor to resign from such office of the company.

**D. Rotation of Partners**

As per Section 139(3), the members of a company may resolve to provide that—

(i) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or

(ii) the audit shall be conducted by more than one auditor.

### 7.2.6 Rules Framed by the Central Government for Rotation of Auditor [Section 139(4)]

As per Section 139(4), the Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors in pursuance of Section 139(2). Accordingly, the Central Government has prescribed the following provisions under Rule 6 of the Company (Audit and Auditor) Rules 2014.

(i) Where a company is required to constitute an Audit Committee u/s 177 of the Act, the Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.

(ii) Where a company is not required to constitute an Audit Committee u/s 177 of the Act, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.

(iii) For the purpose of the rotation of auditors–

(a) the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;

(b) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms. The term "same network" shall include the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

**Note:** For the purpose of rotation of auditors–

(i) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;

(ii) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.

In order to explain the above provisions, Rule 6 has provided the following illustrations (a transition period of 3 years has been provided to a company to comply with mandatory rotation of auditor).

**Illustration 1** In case of individual auditor

| Number of consecutive years for which an individual auditor has been functioning as the auditor in the same company [in the first AGM held after the commencement of provisions of Section 139(2)] | Maximum number of consecutive years for which he may be appointed in the same company (including transitional period) | Aggregate period which the auditor would complete in the same company in view of column I and II |
|---|---|---|
| I | II | III |
| 5 years (or more than 5 years) | 3 years | 8 years or more |
| 4 years | 3 years | 7 years |
| 3 years | 3 years | 6 years |
| 2 years | 3 years | 5 years |
| 1 year | 4 years | 5 years |

**Illustration 2** In case of audit firm including LLP

| Number of consecutive years for which an audit firm has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of [Section 139(2)] | Maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period) | Aggregate period which the firm would complete in the same company in view of column I and II |
|---|---|---|
| I | II | III |
| 10 years (or more than 10 years) | 3 years | 13 years or more |
| 9 years | 3 years | 12 years |
| 8 years | 3 years | 11 years |
| 7 years | 3 years | 10 years |
| 6 years | 4 years | 10 years |
| 5 years | 5 years | 10 years |
| 4 years | 6 years | 10 years |
| 3 years | 7 years | 10 years |
| 2 years | 8 years | 10 years |
| 1 year | 9 years | 10 years |

### 7.2.7 Removal of a Company Auditor

A company auditor can be removed from his office in the following ways:

#### A. Removal of the Auditor before Expiry of his Term

The auditor appointed under Section 139 may be removed from his office before the expiry of his term, subject to the fulfillment of the following conditions under Section 140(1) read with Rule 7 of CAAR 2014:

(i) An application to the Central Government for removal of the auditor shall be made in Form ADT-2. The application shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

(ii) The application shall be made to the Central Government within thirty days of the resolution passed by the Board.

(iii) The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution for removal of the said auditor.

(iv) The auditor concerned shall be given a reasonable opportunity of being heard.

**B. Removal of the Auditor by the Tribunal**

The provisions in relation to removal of an auditor as contained in Section 140(5) are as follows:

(i) The Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, may, by order, direct the company to change its auditor, if it is satisfied that the auditor has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers.

(ii) If the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order to the removal of the auditor from his office.

(iii) The Central Government may appoint another auditor in his place.

(iv) An auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under Section 447.

In addition to the above provisions, any auditor can be removed in the following circumstances as mentioned in the Chartered Accountants Act, 1949.

(i) If the auditor does not communicate with the previous auditor before accepting his appointment in place of the previous auditor.

(ii) If any chartered accountant neglect his professional duties.

(iii) If any chartered accountant starts any venture or is appointed elsewhere, other than the accounting profession, without any prior approval of the Council of Chartered Accountants in India.

(iv) If any chartered accountant violates any provision of the Chartered Accountants Act.

### 7.2.8 Resignation by a Company Auditor

As per Section 140(2) of Companies Act, 2013, a company auditor resigning from his post shall have to comply with the following steps:

(i) The auditor shall file within a period of thirty days from the date of resignation, a statement in the prescribed Form ADT-3 with the company and the Registrar, indicating the reasons and other facts as may be relevant with regard to his resignation.

(ii) In case of companies referred to in sub-section (5) of Section 139, i.e., Govt. Companies, the auditor shall file such statement with the Comptroller and Auditor-General of India.

(iii) If the auditor does not comply with the above provision, he or it shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees.

### 7.2.9 Remuneration of a Company Auditor

The statutory provisions in relation to remuneration of auditors are contained in Section 142 of Companies Act, 2013. These are as under:

(i) The remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. However, the Board may fix remuneration of the first auditor appointed by it.

(ii) The above remuneration shall, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company.

The above remuneration shall be shown under the head 'Other Expenses' in the Statement of Profit and Loss to be prepared as per Schedule III of Companies Act, 2013.

### 7.2.10 Ceiling on the Number of Audit

As per Section 141(3)(g), a person or a partner of a firm shall not be eligible for appointment as the auditor of a company if –

(i) Such person is in full time employment elsewhere; or

(ii) Such person or partner is, at the date of such appointment or reappointment, holding appointment as auditor of more than twenty companies.

Accordingly, the following points are noteworthy:

(i) Each qualified chartered accountant not in full time employment can be the auditor of at most twenty companies.

(ii) In case of a partnership firm, the limit will be twenty companies for each individual partner. That is, for a firm with three partners, the overall limit is $(20 \times 3) = 60$ companies.

(iii) While computing the ceiling in case of a partnership firm, a partner with full time employment elsewhere should not be taken into account.

(iv) If any chartered accountant is a partner in a number of audit firms, then all the firms together will be entitled to audit 20 companies with respect to such common partner.

(v) Similarly, if a chartered accountant is practicing individually and is also the partner in other firm or firms, the overall ceiling with respect to him as individual and also the partner will be 20 companies.

(vi) If any chartered accountant in practice, at any time, holds appointment of more than the specified number of audit assignments of companies, he shall be deemed to be guilty of professional misconduct. (Council General Guidelines 2008, Chapter VIII)

**Note:** While calculating the above ceiling, a joint audit assignment will be taken as one unit. Similarly, if an auditor is appointed to audit even a part of company's accounts, it will be considered as one unit.

**Tutorial Note:** The specified number of tax audit assignment that every auditor, as an individual or as a partner of a firm, can accept is 60 in number.

### 7.2.11 Status of the Company Auditor

There is hardly any consensus among experts regarding the real status of a company auditor. While shareholders may consider him as their agent, to others he may be an officer of the company. Again a third group wants to consider him as a servant of the company. These alternative views regarding the status of an auditor are discussed below:

#### A. Auditor is an Agent of the Shareholders

- **Arguments in Favour:**
  - (i) Except in a few cases where he is appointed by the BOD or by the Central Government, a company auditor is appointed by the shareholders at the AGM of the company. Moreover, even if he is appointed by others, a company auditor is required to protect the interest of the shareholders though his work and to submit the report to them. Hence, he may well be considered as the agent of the shareholders.
  - (ii) In the case, *Spackman* vs. *Evans* (1868), the honourable Justice Cranworth said 'The auditor may be the agent of the shareholders, so far as it relates to the audit of the accounts. For the purpose of the audit, the auditors will bind the shareholders'.
  - (iii) As per Section 182 of the Law of Contract, an agent is a person who is appointed to work on behalf of an individual or an entity or to represent the individual or the entity to any third party. As per the decision of the case, *H. Hedley Byrne Co*. vs. *Heller & Partners Ltd*. (1963), an auditor does have liability to third parties though in a few specified situations. Hence, the auditor can surely be considered as the agent of the company.
- **Arguments Against:**
  - (i) As per Section 183 of the Indian Contract Act, a minor cannot appoint an agent. However, a minor can be a shareholder and accordingly, may have direct role in appointing an auditor. Thus auditor cannot be an agent of the shareholders.
  - (ii) As per Section 213 of the Indian Contract Act, an agent is required to submit accounts to his principal 'on demand'. However, an auditor does not submit any such accounts to the shareholders. Whether demanded or not, he is only to submit his report to the shareholders.
  - (iii) As per Indian Contract Act, 'knowledge of the agent is the knowledge of the principal'. Accordingly, if an auditor is an agent of the shareholder, he is required to inform all information that he will gather during audit. However, in reality, an auditor is not legally bound to do so. His duty is only to report on the financial results and financial state of affairs of the company.

(iv) As per Indian Contract Act, 'he who does by another, does by himself'. Hence, any act of the agent will be considered as the act of the principal. However, this is not true in case of auditor and shareholders. If an auditor distorts any fact in collusion with the directors, shareholders will never be held responsible for that act.

Based on the above arguments, it may be concluded that an auditor is not an agent of the shareholders.

### B. Auditor is an Officer of the Company

- **Arguments in Favour:**

(i) There are a number of legal decisions where an auditor has been treated as an officer of the company. For example, in *London* vs. *General Bank Ltd.* (1895), it was held by Justice Lindley that it seems impossible to deny that for some purposes and to some extent, an auditor is an officer of a company. Similarly, in *Connell* vs. *The Himalaya Bank* (1895), it was held that if an auditor is appointed at the General Meeting and is in receipt of remuneration from the company, he will be considered as the officer of the company.

(ii) As per Section 2(59) of the Companies Act 2013, an auditor will be treated as the officer of the company with respect to the following sections:

**(a)** **Section 299:** Power to summon persons suspected of having property of company;

**(b)** **Section 300:** Power to order examination of promoters, directors, etc.;

**(c)** **Section 336:** Offences by officers of companies in liquidation;

**(d)** **Section 337:** Penalty for frauds by officers;

**(e)** **Section 340:** Power of Tribunal to assess damages against delinquent directors, etc.;

**(f)** **Section 342:** Prosecution of delinquent officers and members of company;

**(g)** **Section 463:** Power of court to grant relief in certain cases.

- **Arguments Against:**

(i) Except in a few cases, companies do not consider the auditor to be its officer.

(ii) In *Findley* vs. *Waddell* (1910) it was held that auditor appointed in a casual vacancy is not an officer of the company.

(iii) In *The Western Counties Steam Bakeries and Milling Co. Ltd*. (1897), it was held that every auditor who was appointed to audit the accounts may not be considered as the officer of the company.

### C. Auditor is a Servant of the Company

Some experts want to consider an auditor to be a servant of the company. They argue that like directors and employees, the auditor also gets remuneration from the company. However, this argument cannot be entertained. A person cannot be called servant only on the ground that he is paid for his service. If this is true, then a lawyer or doctor will also be a servant of the client. In *London* vs. *General Bank Ltd*.(1895) also, it was held that an auditor is not a servant

of the management. In reality, the relation between an auditor and his client is just like an independent professional and his client.

Based on the above discussion, it may be concluded that the real status of a company auditor is debatable. Though, in a few discrete circumstances he is considered as an officer of the company, he should never be viewed as a servant of the company.

## 7.2.12 Rights of an Auditor of a Company

In order to discharge his duties effectively every auditor needs certain rights and power. In case of statutory audit of a company, these rights are entrusted upon the statutory auditor by the Companies Act itself. In addition, every auditor customarily enjoys a few rights based on the decisions of a few case laws.

### A. Right or Power According to Companies Act, 2013

(i) **Right to Inspect Books of Accounts and Vouchers** Every auditor of a company shall have the right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place. In addition, auditor a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries [Section 143(1)].

(ii) **Right to Obtain Information and Explanations** The auditor shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as the auditor [Section 143(1)].

(iii) **Right to Inspect Branch Offices and Branch Accounts** The company auditor is also entitled to inspect the accounts of any branch office in case he considers it necessary in order to discharge his duties as the company auditor. He can do so, even if a separate auditor has already been appointed to audit the branch accounts [Section 143(8)].

(iv) **Right to Receive the Report of Branch Audit from the Branch Auditor** In case a separate auditor has been appointed to audit the branch accounts, the company auditor has the right to receive the branch audit report from the branch auditor so appointed and use it to prepare the overall audit report [Section 143(8)].

(v) **Right to Receive Notices and Attend General Meetings** The company auditor is also entitled to receive all notices of, and other communications relating to, any general meeting and to attend such meetings either by himself or through his authorised representative, who shall also be qualified to be an auditor. The auditor shall also have the right to be heard at such meeting on any part of the business which concerns him as the auditor [Section 146].

(vi) **Right to Sign the Audit Report and Other Documents** The company auditor also has the right to sign the auditor's report or sign or certify any other document of the company in accordance with the provisions of sub-section (2) of Section 141 [Section 145].

**(vii) Right to Have Audit Report Read at the AGM** The company auditor has the right to have the report read before the company in the General Meeting (especially in case the qualifications, observations or comments on financial transactions or matters, mentioned in the auditor's report, have any adverse effect on the functioning of the company) and the same shall be open to inspection by any member of the company [Section 145].

**(viii) Right to Attend the Meeting of the Audit Committee** The auditors of a company shall have a right to attend the meetings of the Audit Committee and to be heard in the meetings when the Committee considers the auditor's report, but shall not have the right to vote [Section 177(7)].

**(ix) Right to be Indemnified** The auditor of a company shall also have the right to be indemnified for any expenses incurred by him in defending himself in case the judgement in any law suit (whether civil or criminal) against the company goes in favour of the auditor.

#### B. Rights or Power Based on Judgements in Case Laws

**(i) Right to Take Legal and Technical Advice** As per the judgement in *London and General Bank* (1985) case, the auditor has every right to take any legal, expert and technical advice in discharging his duty as an auditor. However, the auditor himself has to take the responsibility of any opinion expressed in his report.

**(ii) Right to Claim Remuneration** The auditor has every right to claim remuneration as per the agreement after completion of his duties. He shall also enjoy this right, even if he is removed before the completion of his term [*Homer* vs. *Quitler*, 1908].

Auditor's rights and power are protected by law. Hence, neither any clause of the Articles of Association nor any resolution adopted in any meeting can supersede them.

### 7.2.13 Duties of a Company Auditor

The Companies Act, 2013 contains comprehensive provisions regarding the duties of a company auditor. These are discussed below:

#### A. Duty to Make Enquiry

As per Section 143(1), it is the duty of the auditor to enquire into the following matters:

(i) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms of loan are prejudicial to the interests of the company or its members.

(ii) Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company.

(iii) In case the company is not an investment company or a banking company, whether shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.
(iv) Whether loans and advances made by the company have been shown as deposits.
(v) Whether personal expenses have been charged to revenue account.
(vi) Where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

### B. Duty to Prepare and Submit Report on Financial Statements

According to Section 143(2), the auditor shall prepare and submit a report to the members of the company (i.e. shareholders) on the accounts examined by him and on every financial statements required by or under this Act after taking into account the provisions of this Act, the accounting and auditing standards, etc. Moreover, he has also to report whether in his opinion and according to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year.

### C. Duty Regarding Inclusion of Certain Matters in the Audit Report

As per Section 143(3), the company auditor, in his audit report, shall clearly state –

(i) Whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements.
(ii) Whether, in his opinion, proper books of account as required by the law have been kept by the company and proper returns adequate for the purposes of his audit have been received from branches not visited by him.
(iii) Whether the report on the accounts of any branch office of the company audited by a person other than the company's auditor has been sent to him and the manner in which he has dealt with it in preparing his report.
(iv) Whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns.
(v) Whether, in his opinion, the financial statements comply with the accounting standards.
(vi) The observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company.
(vii) Whether any director is disqualified from being appointed as a director under subsection (2) of Section 164.
(viii) Any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith.

(ix) Whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

### D. Duty to Give Reasons for any Negative Remarks/Qualification

According to Section 143(4), where any of the above mentioned matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons therefor.

### E. Duty to Comply with the Directions of CAG

In the case of a Government company, where the auditor is appointed by the Comptroller and Auditor-General of India, the auditor shall, in his report, include–

(i) The directions, if any, issued by the Comptroller and Auditor-General of India regarding the manner of audit of accounts; and

(ii) The action taken on such directions and its impact on the accounts and financial statement of the company.

### F. Duty to Comply with Auditing Standards

As per Section 143(9), it is the duty of every company auditor to comply with the applicable auditing standards in conduct of his audit.

### G. Duty to Report any Fraud to the Central Government

According to Section 143(12), if an auditor, in the course his audit of a company, finds any fraud involving such amount or amounts as may be prescribed, committed by any officers or employees of the company, he shall immediately report the same to the Central Government within such time and in such manner as may be prescribed. In case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the Audit Committee constituted under Section 177 or to the Board in other cases within such time and in such manner as may be prescribed. [Section 143(12) has been amended by Section 13 of the Companies (Amendment) Act, 2015. However, the same has not been notified yet.]

### H. Duty of Cost Accountant and Company Secretary Regarding Audit

The provisions of this section regarding the duties of an auditor also apply to the cost accountant in practice conducting cost audit under Section 148 and the company secretary in practice conducting secretarial audit under Section 204 [Section 143(14)].

### I. Duty to Pay Penalty

As per Section 15, it will be the duty of every auditor, cost auditor or company secretary to pay fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees, if they fail to comply with the provisions of sub-section (12) of Section 143.

#### J. Duty to Make Comments Sought by the Audit Committee on Certain Matters

According to Section 177(5), it is the duty of the company auditor to offer comments on internal control systems, the scope of audit, including the observations of the auditors and review of financial statement, if asked by the Audit Committee.

#### K. Other Duties under the Companies Act

In addition to the above, the auditor shall have the following duties under the Companies Act, 2013 –

(i) To report on the accounts of the company which will be included in the prospectus of the company while issuing new shares [Section 26].

(ii) To sign on the audit report [Section 145].

(iii) To report on Profit and Loss Account and Balance Sheet of the company to be accompanied with the declaration of the Directors in the event of a company's winding up [Section 305].

The above duties of a company auditor are in accordance with the provisions of the Companies Act, 2013 only. Since an auditor is necessarily a qualified chartered accountant and a registered member of the Institute of Chartered Accountants of India, it shall be the duty of every auditor to follow the professional code of conduct issued by the Institute and to maintain the highest standard of professional integrity in the pursuit of their professional service.

### 7.2.14 Liabilities of an Auditor

An auditor is appointed to verify whether the financial statements prepared based on the books of accounts represent a true and fair view of the financial results and financial state of affairs. In addition, he is also to discharge some other duties as required by the law. Therefore, if an auditor fails to discharge the above duties, he will be legally held liable. Moreover, there are a number of circumstances where an auditor may be held liable either to his appointing authority or any other persons including a third party.

The liabilities of an auditor, and more specifically a company auditor, can be discussed in the following three broad heads:

#### A. Contractual Liabilities

An auditor is usually appointed by a written contract. The contract determines the scope of the audit work. Accordingly, if the auditor violates any term of the contract, he may be held liable under the Contract Act. Even in a case where there is no written contract between the auditor and the appointing authority, he is expected to conduct complete audit. Under such a circumstance, if he conducts partial audit and any error or fraud is discovered later on, he will not be relieved of his liability. The auditor will also be held liable, if he discloses any secret information of the client to any third party. In the case *Wilde and Others* vs. *Cape*

*and Dalgeish* (1897) also, it was held that if the client suffers any loss due to the auditor not complying with the contract, the auditor will have to compensate the client for such loss.

**B. Statutory Liabilities**

Statutory liability of the auditor arises in case of organisations that are legally required their books of accounts audited. In Indian context, the statutory liabilities of an auditor can again be classified into two types — liabilities under Companies Act and liabilities under other Acts.

**I. Liabilities Under the Companies Act**

The Companies Act, 2013 specifies the following two broad categories of liabilities of an auditor:

- **Civil Liabilities** Civil liabilities of an auditor under the Companies Act, 2013 include the following:

  **(i) Civil Liability for Misstatement in the Prospectus** As per Section 35, where a person has subscribed for securities of a company acting on any statement included in the prospectus, or on the inclusion or omission of any matter in the prospectus which is misleading and thereby has sustained any loss or damage and where the auditor as an expert[2] has either made such statement or has given written consent to the issue of the prospectus, he shall be held liable.

  **(ii) Liability for Misfeasance** Misfeasance implies breach of trust or negligence in the performance of duties. As per Section 340, a company auditor may be charged with misfeasance only at the time of liquidation of the company, if it is found that he–

  (a) has misapplied, or retained, or become liable or accountable for, any money or property of the company; or
  
  (b) has been guilty of any misfeasance or breach of trust in relation to the company

- **Criminal Liability** Criminal liabilities of an auditor under the Companies Act, 2013 may arise in the following circumstances:

  **(i) Criminal Liability for Misstatement in the Prospectus** As per Section 34, where the auditor has authorised the issue of any prospectus which includes any statement which is untrue or misleading or where the prospectus has included or omitted any matter which may mislead, the auditor shall be held liable under Section 447. Accordingly (i.e., as per Section 447), the auditor shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

[2] As per the provision of Section 26(5), an auditor being a person is a person who is not, and has not been, engaged or interested in the formation or promotion or management.

**(ii) Punishment for Non-compliance with Sections 139, 143, 144 and 145 of the Act [Section 147]**

(a) In case an auditor makes any false statement to secure his appointment under Section 139, fails to discharge his power and duties under Section 143 in conducting an audit, renders any services which has been prohibited under Section 144 or fails to sign on the audit report and other documents as required by Section 145, he shall be punishable with fine which shall not be less than ₹ 25,000 but which may extend to ₹ 5,00,000.

(b) If an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to 1 year and with fine which shall not be less than ₹ 1,00,000 but which may extend to ₹ 25,00,000.

(c) Convicted auditor shall refund the remuneration received by him from the Company and pay for damages to the company, bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

**(iii) Punishment for Refusal or Failure to Produce Documents** As per Section 217, if any auditor refuses or fails to produce any papers as sought by the inspector appointed by the Central Government to investigate the affairs of a company or by any person authorised by such inspector, he shall be punishable with imprisonment for a term which may extend to six months and with fine ranging from twenty-five thousand rupees to one lakh rupees, and also with a further fine which may extend to two thousand rupees for every day after the first during which the failure or refusal continues.

**(iv) Fraud in Relation to a Company in Winding-up** As per Section 336, if any auditor is engaged in any fraudulent activities in relation to any company in winding up, he shall be punishable with imprisonment for a term which shall not be less than three years but which may extend to five years and with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees.

**(v) Punishment for False Statement** As per Section 448, if any auditor deliberately makes any false statement in any return, report, certificate, financial statement, prospectus, statement or other document required by the act or deliberately omits any material fact, he shall be liable under Section 447 and shall subject to the punishment as stated earlier [Refer to Point (a)].

**(vi) Punishment for False Evidence** As per Section 449, if the auditor or any other person intentionally gives false evidence upon any examination on oath or solemn affirmation or in any affidavit, deposition or solemn affirmation, in or about the winding up of any company or about any matter under this Act, he shall be punishable with imprisonment for a term which shall not be less than three years but which may extend to seven years and with fine which may extend to ten lakh rupees.

## II. Liabilities Under Other Acts

- **Liabilities under Banking Regulation Act, 1949** An auditor's liabilities under Banking Regulation Act, 1949 include the following:

  **(i) Section 46** If an auditor in any return, balance sheet, or other document willfully makes a statement, which is false in any material particulars, knowing it to be false, or willfully omits to make a material statement, he shall be held liable.

  **(ii) Section 45G** An auditor may be publicly examined in the winding up proceedings of a company. If on examination, the High Court is of the opinion that such auditor is not fit to act as an auditor, he shall not act as an auditor of any company for a period not exceeding five years without the permission of the High Court. In case the auditor is a partnership firm, the above provisions shall apply to any partner of such firm.

  - **Liabilities under Life Insurance Act, 1956** As per Section 104 of Life Insurance Act, 1956, if an auditor makes any false statement in any return, report or other such forms to be issued under this Act, he shall be sentenced to imprisonment or fine or both.
  - **Liabilities under Indian Penal Code** Under Section 197 of the Indian Penal code, if any auditor issues or signs any certificate required by law to certify any fact of which such certificate is to be treated as an evidence, knowing or believing that such fact is false in some material aspect, he shall be punishable in the same manner as if he gave false evidence.
  - **Liabilities under Income Tax Act, 1961** As per Section 278 of the Income Tax Act, 1961, if any auditor abets or induces in any manner another person to make and deliver an account, statement or declaration relating to any income chargeable to tax which is false and which the auditor either knows or does not believe to be true, he shall be punished.
  - **Liabilities under Chartered Accountants Act, 1949** Schedule I and II of the Chartered Accountants Act, 1949 contains a list of instances where a chartered accountant shall be guilty of professional misconduct under Section 22 of the Act. However, the instances are only illustrative and the Council of the Institute may hold enquiry about any conduct of the member not mentioned in the above schedules.

## III. Liabilities Established Under Different Case Laws

- **Civil Liabilities for Negligence**

  **(i)** ***Leeds Estate Building and Investment Co.* vs. *Shepherd (1887)*** In this case, Justice Sterling said that the duty of any auditor is not only to check the arithmetical accuracy of the balance sheet but also to evaluate whether the balance sheet exhibits a true view of the state of affairs of the company. If the auditor fails to comply with such duty, he shall be held responsible for negligence and be required to indemnify.

(ii) ***Irish Woolen Co.* vs. *Tyson and Others* (1900)** In this case, it was held that an auditor shall be held responsible, only if it is possible for the auditor to identify the misappropriation by applying appropriate alertness and efficiency, otherwise he shall be relieved.

(iii) ***London Oil Storage Co.* vs. *Seear, Hasluck & Co.* (1904)** In this case, it was held that an auditor shall be held responsible, if he does not take any measure to verify the assets shown in the balance sheet.

(iv) **Liverpool and Wigan Supply Association (1907)** In this case, it was held that an auditor cannot be responsible, if it cannot be proved that the company has suffered any loss due to the negligence of duty by the auditor. Similarly, if the negligence on the part of the auditor is proved but the company does not suffer any loss for such negligence, then also the auditor cannot be held liable.

(v) ***Arther E Green & Co.* vs. *The Central Advance and Discount Corporation* (1920)** In this case it was held that an auditor shall be held responsible, if he accepts any list of the debtors as true in spite of having sufficient doubt over such list of debtors, bad debt and doubtful debts.

(vi) ***Armitage* vs. *Brewer and Knott* (1932)** Here, it was held that an auditor shall be held responsible if he fails to identify any misappropriation by verifying the wages account and voucher in spite of having the information that there is scope for misappropriation.

(vii) ***Superintendent & Remembrancer of legal Affairs, Bengal* vs. *Akhil Bandhu Guha and Others* (1936)** Here, it was held that if an auditor certifies any balance sheet in spite of knowing that the balance sheet does not contain appropriate description of the assets and liabilities, he shall be held responsible.

- **Civil Liability for Misfeasance**

(i) **London and General Bank (1895)** In this case, Justice Lindley said that if an auditor certifies the accounts based on the representation by the directors even if he is not satisfied with it and does not communicate the same to the shareholders through his audit report, he shall be held responsible for misfeasance.

(ii) **Kingston Cotton Mills Co. Ltd. (1896)** Here, it was held that in the absence of any suspicion if an auditor relies on the certificate of the responsible officers of the company, he shall not be held liable for any misfeasance.

(iii) **Republic of Bolivia Exploration Syndicate Ltd. (1913)** Here, it was held that an auditor must know his duties as per the articles of the company and the Companies Act. If the balance sheet does not exhibit the true and fair view of the state of affairs of the company and if the company suffers any loss due to that, it shall be the liability of the auditor to prove that such loss has not arisen due to his misfeasance.

**(iv) The City Equitable Fire Insurance Co. Ltd. (1924)** In this case, it was held that an auditor shall be responsible for any loss of the company as a result of any misstatement of assets in the balance sheet of the company. He shall also be held responsible, if he certifies the investments of the company based on the certificates by any broker without actually verifying the investments.

**(v) Union Bank of Allahabad (1925)** Here, it was held that if an auditor signs the balance sheet without verifying the same just because any responsible officer has signed the same and if the same is proved to be false subsequently, the auditor shall be held responsible.

**(vi) The Westminister Road Construction and Engineering Co. Ltd. (1932)** In this case, it was held that in spite of having sufficient documentary evidence, if an auditor conducts verification of assets and liabilities without examining the same and accordingly fails to identify any overvaluation, he shall be held responsible for misfeasance.

- **Criminal Liabilities**

**(i) Dumbell's Banking Company Ltd. (1900)** In this case, the auditor was held responsible for presenting false balance sheet to the shareholders in spite of knowing the same to be false.

**(ii) Farrow's Bank Ltd.(1921)** In this case, the auditor was held responsible for willfully showing higher profit by overvaluing the assets in the balance sheet. The auditor was sentenced to one year imprisonment.

**(iii) *Official Liquidator of Karachi Bank Ltd.* vs. *Directors, Managers and Auditors of Karachi Bank Ltd.* (1932)** In this case, the auditor was held responsible for certifying the balance sheet in spite of the fact that the directors had included the bad and doubtful debts in profit.

### C. Other Liabilities

Other liabilities of an auditor include the following:

#### I. Liabilities to Third Parties

Every auditor owes duty to the person appointing him for the audit of books of accounts. Accordingly, in case of a sole proprietorship or a partnership firm the auditor is liable to the proprietor or the partners. In case of companies, even though in some cases, auditor is appointed by persons other than the shareholders (such as BOD or Govt.), an auditor has always to report to the shareholders and hence, is liable to them. This liability of the auditor is contractual. Moreover, in case of companies, the Companies Act also specifies a few other liabilities to be abide by the auditors. However, apart from the owners, a number of other stakeholders including the creditors, potential investors, bank, government, and income tax authorities, etc. depend on the audited accounts.

### II. Liabilities in an Honorary Audit

When an auditor is appointed to audit the books of accounts of an organisation, he is expected to discharge all his duty with utmost care and diligence. Therefore, if he fails to discharge his duties subsequently, he may be held liable for either negligence or misfeasance. There is no difference between an auditor receiving remuneration and an honorary auditor in the context of the above liability. An honorary auditor cannot take shelter under the plea that he had taken up the assignment without any remuneration and hence should be relieved of any liability arising from his contract with the client. A contract without any consideration is totally valid in this case and hence, has legal binding on the auditor. In *Fairdeal Corporation, Bombay* vs. *K Gopal Krishna Rao* (1957) case, it was held by the Hon'ble Judge that in respect of the work performed, an honorary auditor is responsible in the same way as an auditor receiving remuneration.

### III. Liabilities in Non-statutory Audit

In case of a sole proprietorship or partnership organisation, audit is not compulsory. Though in a few situations, the owner(s) decides to get their books of accounts audited, that are done to reap a few specific benefits. Since the audit of accounts in these organisations is not legally required, the duties and liabilities are also not specified in any law. However, in such a case also, the auditor cannot escape his liability. Such a liability will primarily arise out of the terms of engagement agreed between the auditor and his client in the agreement undertaken while accepting the appointment. Any violation of the terms of engagement or any negligence of his expected duties will result into breach of contract punishable under the Contract Act.

### IV. Liabilities for Negligence of Assistants

As per the contract between the auditor and the client, it is required on the part of the auditor himself to discharge his duties as per the terms of engagement. However, in practice, the auditor does take the help of audit assistants as per requirement. Since these assistants are appointed by the auditor, it becomes the duty of the auditor to supervise their performance and also to guide them in the audit work. Therefore, if there arises any loss to the client due to any negligence on the part of any audit assistant, the auditor will personally be liable for such loss. In other words, the audit has to ensure that the audit work has been conducted with good care and there is no negligence on the part of the audit assistants. The legal decisions in this respect also support the above notion. In *Henry Squire* vs. *Ball Baker & Co.* (1911), it was held that a principal cannot claim himself to be non-guilty for any negligence on the part of a clerk. Similarly, in *Superintendent of Police* vs. *M. Rajamany* (1981) it was held that an auditor cannot escape liability on the plea that the fault was due to the misconduct by an employee.

## 7.3 BRANCH AUDIT

As per Section 128(1) of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statements for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions

effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

However, the Board of Directors may decide to keep all or any of the books of account aforesaid and other relevant papers at such other place in India. In case such a decision is taken, the company shall, within seven days thereof, file with the Registrar a notice in writing giving the full address of that other place.

In addition to the above, Section 128(2) further specifies that, where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of Section 128(1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place as decided.

Thus, in the light of Section 128(1) and 128(2), there arises the scope of auditing the records of transactions effected at branch office(s) in India or outside India, whether such records are kept at the registered office, branch office or any other place.

Accordingly, Section 143(8) of the Companies Act, 2013, read with Rule 12 of CAAR 2014, specifies the provisions relating to the accounts of a branch office of a company as follows –

(i) Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under Section 139.

(ii) Where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

(iii) The duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be as contained in sub-sections (1) to (4) of Section 143 [Refer to 7.2.13].

(iv) Similarly, if the branch auditor is appointed separately, the duties and powers of the branch auditor shall be as same as applicable to the company auditor under sub-sections (1) to (4) of Section 143.

(v) The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

(vi) Provisions of sub-section (12) of Section 143 regarding reporting of fraud by the auditor shall also extend to the branch auditor to the extent it relates to the concerned branch.

## 7.4 JOINT AUDIT

Joint audit refers to the system of appointing more than one audit firm or individual chartered accountants to conduct the audit of a single organisation. Big companies with diversified

activities often found to appoint several chartered accountants to perform the statutory audit as joint auditors. This is because it ensures pooling together the resources and expertise of multiple auditors to perform the audit work efficiently and within a given time period which may otherwise not be possible for a single auditor.

### 7.4.1 Advantages of Joint Audit

Joint audit offers the following advantages:

(i) Joint audit helps in pooling of expertise of more than one auditor.
(ii) It provides the scope for mutual discussion among the appointed auditors on critical issues. This enhances the effectiveness of the audit work.
(iii) The workload of each individual auditor is sufficiently reduced.
(iv) Joint audit ensures better quality of performance.
(v) The client is least assured about the improved service.
(vi) In case of multinational companies with subsidiaries in different countries which significantly differ in terms of regulatory arrangements, joint audit can spread the work using the expertise of local firms which are in a better position to deal with detailed work and local laws and regulations.
(vii) Joint audit significantly reduces the overall cost of carrying out the work.
(viii) It develops a sense of healthy competition among the joint auditors.
(ix) Since the entire work is divided among different auditors (preferably based on their area of expertise), staff development cost of each individual auditor can be kept within reasonable limits.

### 7.4.2 Limitations of Joint Audit

The general limitations of joint audit are as follows:

(i) There may be ambiguity with respect to the responsibility of each auditor.
(ii) Lack of proper co-ordination among the auditors can be a genuine problem at times.
(iii) There may arise a psychological problem among auditors where firms of different standing are associated in the joint audit.
(iv) Superiority complex of some auditors may invite unnecessary conflict among the auditors.
(v) Areas of common concern may be neglected.
(vi) Uncertainty may arise as regards to the liability of any work done.
(vii) The auditors must share the fees.
(viii) Disagreement among the joint auditors may cause delay in finalisation and submission of the audit report.

### 7.4.3 Regulatory Guidelines in Respect of Joint Audit

The Companies Act, 2013 does not specify any provision as regards to joint audit. However, SA-299 on "Responsibility of Joint Auditor" has prescribed the following guidelines in connection with joint audit of companies.

#### A. Division of Audit Work

(i) **Basis of Division** The joint auditors should divide the audit work among themselves through mutual discussion. Accordingly, the division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, however, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time.

(ii) **Common Areas** Certain areas of work, owing to their importance or the nature of the work involved, will not be divided and thus, will be covered by all the joint auditors.

(iii) **Documentation and Communication** The division of work among joint auditors as well as the areas of work to be covered by all should be adequately documented and preferably communicated to the entity.

#### B. Co-ordination

The joint auditors must co-ordinate amongst themselves in course of the audit work. Accordingly, if a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention or require disclosure or discussion with or application of judgement by other joint auditor(s), he should communicate the same to all the other joint auditors in writing in the form of a report or note prior to the finalisation of the audit. Otherwise, the other joint auditors will not be responsible in respect of such information.

#### C. Responsibility of a Joint Auditor

For the audit work divided among themselves, each joint auditor is responsible only for the work allocated to him. Accordingly, among other duties,

(i) Each joint auditor is required to scrutinise the audit report of the branch/divisions specifically allocated to him.

(ii) Each joint auditor is required to obtain and evaluate information and explanations from the management of the divisions, zones or units specifically allocated to him.

However, they shall be jointly and severally responsible for the following:

(a) In respect of undivided work.

(b) In respect of decision taken jointly regarding the nature, timing or extent of audit procedures to be performed by any of the joint auditor. (However, they will be

responsible only with respect to the appropriateness of the decision, proper execution of the audit procedures is the separate and specific responsibility of the joint auditor concerned.)

(c) In respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among them.

(d) In respect of compliance with disclosure requirement (ie. Notes on accounts) of the relevant statute while examining the financial statements.

(e) For ensuring that the audit report complies with the requirements of the relevant statute.

#### D. Reliance on the Work of Other Joint Auditor

It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in accordance with the generally accepted audit procedures. However, each joint auditor is entitled to rely on the other joint auditors for bringing to his notice any departure from the generally accepted accounting principles or any material error noticed in the course of the audit.

#### E. Reporting Responsibility

Normally, the joint auditors are able to submit a unanimous audit report. However, in case they disagree with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of the majority of them.

## 7.5 MAINTENANCE OF BOOKS OF ACCOUNTS

Section 128 of the Companies Act, 2013 has suggested the following provisions in relation to the maintenance of proper books of accounts by a company.

### 7.5.1 Mode of Maintenance

According to Section 128(1), every company shall its prepare books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches. Such books shall be kept on accrual basis and according to the double entry system of accounting. Moreover, such books may be maintained in electronic form.

In case the books of accounts and other relevant papers are kept in electronic form, the company must consider the following provisions as contained in Rule 3 of the Companies (Accounts) Rules, 2014:

(i) The books of account and other relevant books and papers maintained in electronic mode shall remain accessible in India so as to be usable for subsequent reference.

(ii) The books of account and other relevant books and papers shall be retained completely in the format in which they were originally generated, sent or received, or in a format which shall present accurately the information generated, sent or received and the information contained in the electronic records shall remain complete and unaltered.

(iii) The information received from branch offices shall not be altered and shall be kept in a manner where it shall depict what was originally received from the branches.

(iv) The information in the electronic record of the document shall be capable of being displayed in a legible form.

(v) There shall be a proper system for storage, retrieval, display or printout of the electronic records as the Audit Committee, if any, or the Board may deem appropriate and such records shall not be disposed of or rendered unusable, unless permitted by law.

(vi) The back-up of the books of account and other books and papers of the company maintained in electronic mode, shall be kept in servers physically located in India on a periodic basis.

(viii) The company shall intimate to the Registrar on an annual basis at the time of filing of financial statement–

  (a) the name of the service provider;
  (b) the internet protocol address of service provider;
  (c) the location of the service provider (wherever applicable);
  (d) where the books of account and other books and papers are maintained on cloud, such address as provided by the service provider.

### 7.5.2 Place of Maintenance

Section 128(1) also provides that every company shall keep proper books of accounts at its registered office. However, all or any of the books of account aforesaid and other relevant papers may also be kept at such other places in India, if the Board of Directors so decide. In such a case, the company shall, within seven days of such decision, file with the Registrar a notice in writing giving the full address of that other place.

### 7.5.3 Accounts of the Branch Office

As per Section 128(2), where a company has a branch office in India or outside India, proper books of account relating to the transactions effected at the branch office may be kept at that office and proper summarised returns periodically be sent by the branch office to the company at its registered office or the other place as referred to in Section 128(1).

### 7.5.4 Inspection of Books of Accounts

As per Section 128(3), the books of account and other books and papers maintained by the company within India shall be open for inspection at the registered office of the company or at such other place in India by any director during business hours. In case of any financial information maintained outside the country, copies of such financial information shall be

maintained and produced for inspection by any director. To state further, the inspection in respect of any subsidiary of the company shall be done only by the person authorised in this behalf by a resolution of the Board of Directors.

Again, Section 128(4) states that, where an inspection is made under sub-section (3), the officers and other employees of the company shall give to the person making such inspection all assistance in connection with the inspection.

In addition to the above provisions, Rule 4 of the Companies (Accounts) Rules, 2014 provides the following with respect to the inspection of the books of accounts:

(i) The summarised returns of the books of account of the company kept and maintained outside India shall be sent to the registered office at quarterly intervals, which shall be kept and maintained at the registered office of the company and kept open to directors for inspection.

(ii) Where any other financial information maintained outside the country is required by a director, the director shall furnish a request to the company setting out the full details of the financial information sought, the period for which such information is sought, etc.

(iii) The company shall produce such financial information to the director within fifteen days of the date of receipt of the written request.

(iv) The financial information required as above shall be sought for by the director himself and not by or through his power of attorney holder or agent or representative.

### 7.5.5 Period of Maintenance of Books of Accounts

According to Section 128(5), every company shall preserve the books of accounts together with all the relevant vouchers in good condition for a period of not less than next eight years. However, where an investigation has been ordered in respect of the company under Chapter XIV, the Central Government may direct the company that the books of account may be kept for such longer period as it may deem fit.

### 7.5.6 Default in Maintaining Proper Books of Accounts and Liability Thereof

Section 128(6) specifies the following persons to be in charge with the duty of complying with the provisions of maintenance of proper books of accounts –

(i) Managing director;

(ii) The whole-time director in charge of finance;

(iii) The Chief Financial Officer; or

(iv) Any other person of a company who has been charged by the Board in this respect.

Accordingly, if there is any contravention with regard to such provisions, the above persons shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees or with both.

## 7.6 RELATED PARTY DISCLOSURES

During the course of business operations, often transactions are entered into between a company and its officials or a party related to any such officials. Although, these transactions do not necessarily indicate any fraudulent intention, yet, at times, they do result in material misstatement leading to a distorted presentation of the performance and financial state of affairs through the financial statements. Hence, an auditor needs to be extra cautious while dealing with such relationships and transactions and follow all relevant regulatory guidelines.

The provisions in this context has three sources –

(i) Ind AS-24 on 'Related Party Disclosures' (Previously AS-18).
(ii) Companies Act, 2013 along with Company Rules.
(iii) SA-550 on 'Related Parties'.

### 7.6.1 Provisions of Ind AS-24: Related Party Disclosures

**A.** As per Ind AS-24, a related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

**B.** A 'related party' is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(i) A person or a close member of that person's family is related to a reporting entity, if that person:
  (a) has control or joint control of the reporting entity;
  (b) has significant influence over the reporting entity; or
  (c) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(ii) An entity is related to a reporting entity if any of the following conditions applies:
  (a) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
  (b) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
  (c) Both entities are joint ventures of the same third party.
  (d) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
  (e) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
  (f) The entity is controlled or jointly controlled by a person identified in (i).
  (g) A person identified in (i) (a) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

(h) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

**C. Disclosure to be Made by all Entities**

- Relationships between a parent and its subsidiaries shall be disclosed irrespective of whether there have been transactions between them. An entity shall disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed. (Paragraph 13)
- An entity shall disclose key management personnel compensation in total and for each of the following categories (Paragraph 17):
  (i) short-term employee benefits;
  (ii) post-employment benefits;
  (iii) other long-term benefits;
  (iv) termination benefits; and
  (v) share-based payment.
- If an entity obtains key management personnel services from another entity (the 'management entity'), the entity is not required to apply the above requirements to the compensation paid or payable by the management entity to the management entity's employees or directors. (Paragraph 17A)
- If an entity has had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements. These disclosure requirements are in addition to those in paragraph 17. At a minimum, disclosures shall include:
  (i) the amount of the transactions;
  (ii) the amount of outstanding balances, including commitments, and:
    (a) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
    (b) details of any guarantees given or received;
  (iii) provisions for doubtful debts related to the amount of outstanding balances; and
  (iv) the expense recognised during the period in respect of bad or doubtful debts due from related parties. (Paragraph 18)
- Amounts incurred by the entity for the provision of key management personnel services that are provided by a separate management entity shall be disclosed. (Paragraph 18A)
- The above disclosures shall be made separately for each of the following categories (Paragraph 19):

(i) the parent;
(ii) entities with joint control of, or significant influence over, the entity;
(iii) subsidiaries;
(iv) associates;
(v) joint ventures in which the entity is a joint venturer;
(vi) key management personnel of the entity or its parent; and
(vii) other related parties.

- Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity. (Paragraph 24)

**D. Disclosures to be Made by only Government-related Entities**

- A reporting entity is exempt from the disclosure requirements of paragraph 18 in relation to related party transactions and outstanding balances, including commitments, with:
  (i) a government that has control or joint control of, or significant influence over, the reporting entity; and
  (ii) another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity. (Paragraph 25)
- If a reporting entity applies the exemption in paragraph 25, it shall disclose the following about the transactions and related outstanding balances referred to in paragraph 25:
  (i) the name of the government and the nature of its relationship with the reporting entity (i.e. control, joint control or significant influence);
  (ii) the following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:
    (a) the nature and amount of each individually significant transaction; and
    (b) for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

## 7.6.2 Provisions of Companies Act, 2013

**A. Definition**

According to Section 2(76) of the Companies Act, 2013, 'related party', with reference to a company, shall mean–

(i) a director other than an independent director [as notified via Notification No. G.S.R. 507(E) dated 17.07.2014] or his relative;
(ii) a key managerial personnel or his relative;
(iii) a firm, in which a director, manager or his relative is a partner;
(iv) a private company in which a director or manager is a member or director;

(v) a public company in which a director or manager is a director or holds along with his relatives, more than two per cent of its paid-up share capital;

(vi) any body corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager;

(vii) any person on whose advice, directions or instructions a director or manager is accustomed to act:

[However, if the persons as mentioned in sub-clauses (vi) and (vii) provides any advice, directions or instructions in a professional capacity, they shall not be treated as related parties.]

(viii) any company which is–

(a) a holding, subsidiary or an associate company of such company; or

(b) a subsidiary of a holding company to which it is also a subsidiary;

(ix) such other person as may be prescribed.

**B. Related Party Transactions**

Section 188 of the Companies Act, 2013 read with the Companies (Meeting of Board and its Powers) Rules, 2014 contains the following provisions in respect of related party transactions.

**I. Consent of the BOD [Section 188(1) and Rule 15]** Except with the prior approval of the Board of Directors given by a special resolution at a meeting of the Board,

(i) a company having a paid-up share capital of ten crore rupees or more shall not enter into a contract or arrangement with any related party; or

(ii) a company shall not enter into a transaction or transactions, where the transaction or transactions to be entered into–

(a) as contracts or arrangements with criteria, as mentioned below:

1. sale, purchase or supply of any goods or materials directly or through appointment of agents exceeding twenty five per cent of the annual turnover.
2. selling or otherwise disposing of, or buying, property of any kind directly or through appointment of agents exceeding ten per cent of net worth.
3. leasing of property of any kind exceeding ten per cent of the net worth or exceeding ten per cent of turnover.
4. availing or rendering of any services directly or through appointment of agents exceeding ten per cent of the net worth.

(b) with respect to appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding two and half lakh rupees.

(c) with respect to remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding one per cent of the net worth.

Moreover, the agenda of the Board meeting at which the special resolution is proposed to be moved shall disclose–

(i) the name of the related party and nature of relationship;
(ii) the nature, duration of the contract and particulars of the contract or arrangement;
(iii) the material terms of the contract or arrangement including the value, if any;
(iv) any advance paid or received for the contract or arrangement, if any;
(v) the manner of determining the pricing and other commercial terms, both included as part of contract and not considered as part of the contract;
(vi) whether all factors relevant to the contract have been considered, if not, the details of factors not considered with the rationale for not considering those factors; and
(vii) any other information relevant or important for the Board to take a decision on the proposed transaction.

However, nothing in this sub-section shall apply to any transactions entered into by the company in its ordinary course of business other than transactions which are not on an arm's length basis.

**II. Restriction on the Interested Director [Section 188(1) and Rule 15(2)]** Where any director is interested in any contract or arrangement with a related party, such director shall not be present at the meeting during discussions on the subject matter of the resolution relating to such contract or arrangement. Similarly, the member who is a related party shall not cast vote on such special resolution.

**III. Offering Justification in Board's Report [Section 188(2)]** The BOD must offer justification of each of such contract or arrangement entered with any related party in its report to the shareholders.

**IV. Treatment of Unauthorised Contracts [Section 188(3)]** Where any contract or arrangement is entered into by a director or any other employee, without obtaining the consent of the Board or approval by any special resolution in the general meeting and if it is not ratified by the Board or, as the case may be, by the shareholders at a meeting within three months from the date on which such contract or arrangement was entered into, such contract or arrangement shall be voidable at the option of the Board and if the contract or arrangement is with a related party to any director, or is authorised by any other director, the directors concerned shall indemnify the company against any loss incurred by it.

**V. Penalty for any Violation** Any director or any other employee of a company, who had entered into or authorised the contract or arrangement in violation of the provisions of this section shall–

(i) in case of listed company, be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees, or with both; and

(ii) in case of any other company, be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees.

### 7.6.3 Guidelines on Related Party Transactions under Standard on Auditing 550

SA-500 on 'Related Parties' provides extensive guidelines relating to transactions with related parties and auditor's duty thereof. These are briefly discussed as follows:

#### A. Nature of Related Party Transactions

Many related party transactions are in the normal course of business and accordingly carry no higher risk of material mis-statement. However, in some circumstances, a few such transactions may give rise to high risk of material mis-statement, especially when the related parties operate through an extensive and complex range of relationship and structure, the information system is ineffective at identifying or summarising transactions and outstanding balances with related parties and the transactions are conducted other than the normal market terms.

#### B. Auditor's Responsibilities

Often financial reporting framework establishes specific accounting and disclosure requirements for related party relationships and transactions. Hence, in such cases, it will be the duty of the auditor to perform audit procedure to identify, assess and respond to the risk of material misstatement arising from the entity's failure to appropriately account for or disclose such relationships and transactions in accordance with the requirements of the framework. Even if the applicable financial reporting framework establishes no related party requirements in a given situation, the auditor still needs to obtain an understanding of such relationships and transactions to be able to conclude whether the financial statements affected by those transactions –

(i) achieve a true and fair presentation; and
(ii) are not misleading.

Hence, planning and performing the audit with professional skepticism and alertness is, therefore, particularly important in this context, given the potential for undisclosed related party relationships and transactions.

#### C. Objective of the Auditor

Irrespective of whether the applicable financial reporting framework establishes any requirements in relation to the related party relationships and transactions, the objective of the auditor will be –

(i) to obtain an understanding of such relationship and transactions to be able to –
  (a) recognise fraud risk factors, if any; and
  (b) conclude whether the financial statements achieve a true and fair presentation; and are not misleading.
(ii) to obtain sufficient appropriate audit evidence about whether such relationships and transactions have been appropriately identified, accounted for and disclosed.

**D. Risk Assessment Procedure to be Followed**

The auditor shall perform the audit procedure and related activities to obtain information relevant to identifying the risk of material misstatements associated with related party relationships and transactions. For this purpose the auditor must ensure the following:

**(i) Understanding the Entity's Related Party Relationships and Transactions** In order to have a proper understanding the entity's related party relationships and transactions, the auditor shall inquire of the management with regard to –

(a) the identity of entity's related parties, including changes from the prior period;
(b) the nature of relationships;
(c) whether the entity has entered into any transactions with them and, if so, the type and purpose of the transactions.

Additionally, the auditor shall perform audit procedure to obtain an understanding of the controls, if any, that the management has established to –

(a) identify, account for and disclose such relationships and transactions in accordance with the applicable framework.
(b) authorise and approve significant transactions with the related parties;
(c) authorise and approve significant transactions outside the normal course of business.

**(ii) Maintaining Alertness for Related party Information when Reviewing Records or Documents** The auditor shall remain alert while inspecting records and documents for any arrangements or other information that may indicate the existence of any related party relationships and transactions that the management has not previously identified or disclosed.

**(iii) Sharing Related Party Information with the Engagement Team** The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team.

**E. Identification and Assessment of the Risks of Material Misstatements**

**(i) Risk Associated with Related Party Relationships and Transactions** The auditor shall identify and assess the risk of material misstatement associated with related party relationships and transactions and determine whether such risks are significant.

**(ii) Responses to the Risks** The auditor shall design and perform further audit procedures to obtain sufficient appropriate audit evidence about assessed risk of material misstatement.

**(iii) Identification of Previously Unidentified and Undisclosed Relationships and Significant Transactions** If the auditor identifies related parties or significant related party transactions that the management has not previously identified or disclosed to the auditor, the auditor shall –

(a) promptly communicate the relevant information to the other members of the engagement team.

(b) where the applicable financial reporting framework establishes requirements, request the management to identify all transactions with the newly identified parties and inquire the reason why entity's control failed to identify them.
(c) perform appropriate substantive audit procedures relating to the newly identified related parties or significant related party transactions.
(d) re-consider the risk.
(e) evaluate the implications for the audit if the non-disclosure by management appears to be intentional.

(iv) **Identified Significant Related Party Transactions Outside the Entity's Normal Course of Business** For identified significant related party transactions outside the entity's normal course of business, the auditor shall –

(a) inspect the underlying contract and evaluate whether they are entered into or engaged in fraudulent reporting or concealing misappropriation of assets, their terms are consistent with the management's explanations and they are appropriately accounted for and disclosed.
(b) Obtain audit evidence that they are appropriately authorised.

(v) **Assertions by Management Regarding Conduct of Related Party Transactions on Terms Equivalent to those Prevailing in an arm's Length Transaction** Where the management has made an assertion that the related party transactions have been undertaken on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

(vi) **Evaluation for Accounting and Disclosure** In forming an opinion on the financial statements, the auditor shall evaluate whether the identified related party transactions have been properly accounted for and disclosed in accordance with the applicable reporting framework and whether the financial statements have achieved true and fair presentation and not misleading.

### F. Written Representations

The auditor shall obtain written representations from the management and those charged with the governance that

(i) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions that they are aware of; and
(ii) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

## 7.7 SEGMENT REPORTING

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. In such a situation, assessing the risks and returns of a diversified or multi-locational

enterprise may not be possible from the aggregated data. Rather, information about different types of products and services of an enterprise and its operations in different geographical areas—often called segment information—will be more relevant in such an exercise. Therefore, reporting of segment information is widely regarded as necessary for meeting the needs of users of financial statements.

### 7.7.1 Advantages of Segment Reporting

(i) Segment information helps to better assess the performance of an entity.
(ii) Segment information helps to better assess and manage the risks of an entity.
(iii) Segment information helps the users in making more informed judgement about the enterprise as a whole.
(iv) An entity can ensure optimal allocation of resources among the segments based on segment information reported.
(v) Segment information helps the management in better forecasting the future cash flows of the entity. Aggregate information often found to be inappropriate in this respect.
(vi) Segment information helps the management in making various policy decisions that have long-term implications in sustaining competitive advantages.

### 7.7.2 Disadvantages of Segment Reporting

(i) Arbitrary segmentation without carefully considering factors like revenue generation, return and risk may lead to serious problem in compiling information meaningfully.
(ii) Segment reporting may lead to information overload. As a result, it becomes difficult to identify information that has true significance.
(iii) In large organisations, segment reporting may be really expensive and time consuming.

### 7.7.3 Provisions of Ind AS-108, 'Operating Segment'

In India, segment reporting by eligible entities is guided by Ind AS-108, Operating Segment. Some of the important points of this standard are discussed below:

#### A. Core Principle

An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. Such information may be termed as 'Segment Information'.

#### B. Scope

(i) This Accounting Standard shall apply to companies to which Indian Accounting Standards (Ind ASs) notified under the Companies Act, 2013 apply.
(ii) If an entity that is not required to apply this Ind AS chooses to disclose information about segments that does not comply with this Ind AS, it shall not describe the information as segment information.

(iii) If a financial report contains both the consolidated financial statements of a parent that is within the scope of this Ind AS as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

### C. Concept of Operating Segments

An operating segment is a component of an entity:

(i) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),

(ii) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

(iii) for which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

### D. Aggregation Criteria

Operating segments often exhibit similar long-term financial performance, if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments, would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment, if aggregation is consistent with the core principle of this Ind AS, the segments have similar economic characteristics, and the segments are similar in each of the following respects:

(i) The nature of the products and services

(ii) The nature of the production processes

(iii) The type or class of customer for their products and services

### E. Identification of Reportable Segments; Quantitative Thresholds

An entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:

(i) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 per cent or more of the combined revenue, internal and external, of all operating segments.

(ii) The absolute amount of its reported profit or loss is 10 per cent or more of the greater, in absolute amount, of (a) the combined reported profit of all operating segments that did not report a loss and (b) the combined reported loss of all operating segments that reported a loss.

(iii) Its assets are 10 per cent or more of the combined assets of all operating segments.

In addition to above, the management may choose any segment to be reportable at their discretion.

An entity may combine information about operating segments that do not meet the quantitative thresholds with information about other operating segments that do not meet the quantitative thresholds to produce a reportable segment, only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria.

If the total external revenue reported by operating segments constitutes less than 75 per cent of the entity's revenue, additional operating segments shall be identified as reportable segments until at least 75 per cent of the entity's revenue is included in reportable segments.

Information about other business activities and operating segments that are not reportable shall be combined and disclosed in an 'all other segments' category.

If management judges that an operating segment identified as a reportable segment in the immediately preceding period is of continuing significance, information about that segment shall continue to be reported separately in the current period even if it no longer meets the criteria for reportability.

If an operating segment is identified as a reportable segment in the current period in accordance with the quantitative thresholds, segment data for a prior period presented for comparative purposes shall be restated to reflect the newly reportable segment as a separate segment, unless the necessary information is not available and the cost to develop it would be excessive.

### F. Disclosure Requirements

An entity shall disclose the following for each period for which a statement of profit and loss is presented.

**I. General Information** An entity shall disclose the following general information:

(i) Factors used to identify the entity's reportable segments;
(ii) The judgements made by the management in applying the aggregation criteria; and
(iii) Types of products and services from which each reportable segment derives its revenues.

**II. Information About Profit or Loss**

(i) Revenues from external customers;
(ii) Revenues from transactions with other operating segments of the same entity;
(iii) Interest revenue;
(iv) Interest expense;
(v) Depreciation and amortisation;
(vi) Material items of income and expense disclosed in accordance with paragraph 97 of Ind AS-1, Presentation of Financial Statements;
(vii) The entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;

(viii) Income tax expense or income; and

(ix) Material non-cash items other than depreciation and amortisation.

**III. Information about Assets and Liabilities**

(i) The amount of investment in associates and joint ventures accounted for by the equity method, and

(ii) The amounts of additions to non-current assets other than financial instruments, deferred tax assets, net defined benefit assets and rights arising under insurance contracts.

**IV. Measurement** An entity shall provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment. At a minimum, an entity shall disclose the following:

(i) The basis of accounting for any transactions between reportable segments.

(ii) The nature of any differences between the measurements of the reportable segments' profits or losses, assets and liabilities with that of the entity.

(iii) The nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss.

(iv) The nature and effect of any asymmetrical allocations to reportable segments.

**V. Reconciliations** An entity shall provide reconciliations of all of the following:

(i) The total of the reportable segments' revenues, profit and loss, assets and liabilities to that of the entity.

(ii) The total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity.

**VI. Restatement of Previously Reported Information** If an entity changes the structure of its internal organisation in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier periods, including interim periods, shall be restated unless the information is not available and the cost to develop it would be excessive.

**VII. Entity-wide Disclosures** The following information shall be provided, only if it is not provided as part of the reportable segment information required by this Ind AS.

(i) Information about products and services

(ii) Information about geographical areas

(iii) Information about major customers

### 7.7.4 Auditor's Duty Regarding Segment Reporting

The duties of an auditor regarding segment reporting are as follows:

(i) The auditor must verify the process of identification of reportable segments and see that it is in accordance with provisions of Ind AS-108.

(ii) In case certain segments are aggregated for the purpose of reporting, the auditor must verify whether the aggregation criteria have been properly followed.
(iii) The auditor must verify whether the entity has disclosed all required information relating to the profit and loss of each segment.
(iv) The auditor must verify whether the entity has disclosed all required information relating to the assets and liabilities of each segment.
(v) The auditor must verify the explanation provided by the entity regarding measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment.
(vi) He shall also verify the disclosure made by the entity regarding the adherence of accounting policies in treating the inter-segment revenues and nature of any difference between segment measure and enterprise measure of an item.
(vii) The auditor shall also verify the reconciliation of segment revenue, profit and loss, assets and liabilities with that of the enterprise.
(viii) The auditor shall be extremely careful in examining the restatement of previously reported information due to change in the structure of internal organisation.
(ix) The auditor shall carefully examine the compliance with the disclosure requirements with respect to the enterprise-wide disclosures, especially the information about major customers.

## 7.8 DIVISIBLE PROFITS AND DIVIDENDS

### 7.8.1 Meaning of Profit

The prime objective of each and every business organisation is to earn profit. This is because profit ensures survival and long term growth of an organisation. At the same time, profit ensures payment of adequate compensation to various capital providers including the owners or shareholders. Though 'profit' is so important, the term has not been defined in any contemporary statute. Even there is significant difference between the explanation given by economists and accountants. Moreover, the legal decisions in this context are also not adequate to define the term appropriately.

Thus, considering the broad use of the term in the business literature, it can be said that profit is the surplus available from the revenue generated in a period after deducting the expenditure attributable to such revenue. The Institute of Chartered Accountants of India, in its guidance notes on 'Terms used in Financial Statements', has also defined the term 'profit' as 'the excess of revenue over related costs'.

### 7.8.2 Incorrect Calculation of Profit and its Consequences

Since profit is very closely associated with the interest of owners and various other stakeholders, determination of accurate profit is utmost important from business perspective. Both inflated and deflated profits amount to serious consequences for a business that are hard to withstand. These consequences are discussed below:

| Consequences of Inflated Profit | Consequences of Deflated Profit |
|---|---|
| (i) Payment of dividend out of inflated profit leads to capital erosion. Such practice, if continued for long, may risk the very existence of the organisation. | (i) Showing less profit than actual deprives the owners of their rightful claim. |
| (ii) Erosion of capital as above reduces the safety of the interest of the creditors. | (ii) If directors' remuneration is linked to profit, showing less profit means depriving them of their legitimate remuneration. |
| (iii) Showing inflated profits continuously weakens the financial health of the organisation. | (iii) Showing less profit by overvaluing the assets or undervaluing the liabilities results into secret reserve. Creation of any secret reserve is prohibited by the Companies Act. |
| (iv) Payment of dividend out of inflated profit results into payment of dividend out of capital which is prohibited under the Companies Act. | (iv) Since lower profit means lower debt servicing capacity, this practice hampers the credibility of the organisation to the debt providers. |
| (v) Since this practice is basically a manipulation by management, when disclosed, it hampers investors' trust on the company. | (v) Showing less profit on a continuous basis amounts to loss of goodwill of the organisation. |
| (vi) Since bonus of the employees depends on profit, showing higher profit means payment of higher bonus. | (vi) Showing less profit than actual helps in tax evasion which is illegal. |
| (vii) Showing higher profit results into higher tax outgo. | |

### 7.8.3 Meaning of Divisible Profit

The concept of divisible profit is specifically relevant for a corporate form of organisation. This is because, in a sole proprietorship or partnership firm, the entire profit is credited to the owner's or partners' capital account, which they can withdraw at any time subsequently. However, a company may decide not to pay its entire profit for an accounting period to its shareholders and may keep necessary reserves. Hence, the part of the profit of a company which is legally distributed among the shareholders as dividend, it called divisible profit.

#### A. Concept of 'Divisible Profit' as per Legal Decisions

The above definition of 'divisible profit' has been upheld in various legal decisions. For example:

(i) In *Fisher* vs. *Black and White Publishing Co.* (1901) case, it was held that profit available after statutory deduction by the directors will be called divisible profit.

(ii) Similarly, in *Buenos Aires Great Southern Railway Co. Ltd*. vs. *Prestone* (1947) case, it was held that divisible profit refers to the profit left after setting aside to reserves or after carrying forward such amounts as the directors think fit.

**B. Concept of 'Divisible Profit' as per Companies Act**

Companies Act, 2013 does not explicitly define the term 'divisible profit'. However, as per Section 123(1), a company can pay dividend out of profit only after providing for depreciation. Moreover, a company, before declaring dividend may transfer to reserve such amount as it considers appropriate.

## 7.8.4 Profit vs. Divisible Profit

Though used interchangeably in a number of situations, the terms 'profit' and 'divisible profit' are not the same. Profit is the surplus of revenue over cost. But divisible profit is the portion of profit which is legally available for distribution among the shareholders as dividend. In short profits net of various appropriations, either statutory or voluntary, result into divisible profit.

## 7.8.5 Dividend

**A. Concept and Definition**

As per Oxford Dictionary, 'dividend' means 'sum payable as profit of Joint Stock Company or to creditors of insolvent estate'. However, in business literature, 'dividend' is simply defined as the share of a company's profit that is distributed among the shareholders.

As per Section 2(35) of the Companies Act, 2013, the term 'dividend' also includes interim dividend (i.e., dividend paid before the conclusion of the accounting year for which the dividend is being paid).

Again Income Tax Act, 1961, in addition to the above, also includes certain other payments known as 'deemed dividend' within the scope of the term 'dividend'. As per Section 2(22), dividend includes–

(i) Distribution of company's assets among its shareholders.
(ii) Distribution of debentures, debenture stock or deposit certificates in any form to its shareholders and distribution of bonus shares to the preference shareholders.
(iii) Distribution made by a company to its shareholders on its liquidation.
(iv) Distribution at the time of capital reduction.
(v) Loan and advances to Directors and their family members.

The above distributions, to the extent of accumulated profit of the company (whether capitalised or not) are treated as dividend.

The Institute of Chartered Accountants of India, in its guidance notes on 'Terms used in Financial Statements', has defined 'dividend' as 'a distribution to shareholders out of profits or reserves available for this purpose'.

To conclude, 'dividend' may be defined as the part of corporate earnings that are not retained in the business and eventually distributed among the shareholders.

**B. Types of Dividend**

Dividend can be classified in different ways as follows:

**(i) Based on the Shares on which it is paid**

(a) Preference Dividend i.e. dividend payable on preference shares.
(b) Equity Dividend i.e. dividend payable on equity shares.

**(ii) Based on the Mode of Payment**

(a) Cash Dividend i.e. dividend which is paid in cash.
(b) Bonus Dividend i.e. issuing shares without consideration by capitalizing the reserves.

**Note:** Dividend can also be paid by distributing any asset of the company instead of cash or by issuing any other securities.

**(iii) Based on Timing**

(a) Interim Dividend i.e. dividend paid within a financial year before determining the final profits.
(b) Final Dividend i.e. dividend paid at the end of the financial year out of the final divisible profit.

## 7.8.6 Provisions of Companies Act, 2013 Regarding Payment of Dividend

The provisions of Companies Act, 2013 in respect of payment of dividend are as follows:

**A. Source of Dividend**

According to Section 123(1), a company can declare or pay dividend for any financial year only–

(i) out of current year's profits after providing for depreciation; and/or
(ii) out of the undistributed profits for any previous financial year or years after providing for depreciation; or
(iii) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

**B. Depreciation**

For the purpose of arriving at the profits to be eligible for distribution of dividend, depreciation shall be provided in accordance with Schedule II of the Companies Act, 2013. [Section 123(1)]

### C. Transfer to Reserve

A company may before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company [Section 123(1)].

### D. Declaration of Dividend out of Accumulated Profit

According to Section 123(1) read with Companies (Declaration and Payment of Dividend) Rules 2014, In the event of inadequacy or absence of profits in any year, a company may declare dividend out of free reserves subject to the fulfillment of the following conditions:

(i) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year:

However, this rule will not be applicable to a company, which has not declared any dividend in each of the three preceding financial year.

(ii) The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(iii) The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(iv) The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid up share capital as appearing in the latest audited financial statement.

(v) No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year. The loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

['Free Reserves' for this purpose shall mean such reserves which are available for distribution as dividend. It shall not include any amount representing unrealised gains, notional gains or revaluation of assets, or any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value.]

### E. Interim Dividend

The Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared:

However, if the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years [Section 123(3)].

#### F. Amount of Dividend to be Deposited in a Separate Account

The amount of the dividend, including interim dividend, shall be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend [Section 123(4)].

#### G. Mode of Payment of Dividend

Dividend in respect of any share shall be paid only to the registered shareholder of such share or to his order or to his banker and shall not be payable except in cash. Further, any dividend payable in cash may be paid by cheque or warrant or in any electronic mode to the shareholder entitled to the payment of the dividend.

A company may also capitalise profits or reserves for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company [Section 123(5)].

#### H. Restriction on Companies Failed to Comply with the Provisions of Sections 73 and 74

A company which fails to comply with the provisions of Sections 73 and 74 shall not declare any dividend on its equity shares, so long as such failure continues [Section 123(6)].

### 7.8.7 Auditor's Duty Regarding Payment of Dividend

Since the payment of dividend by a company is governed by the provisions of Companies Act, the auditor's in this respect will be limited to the verification that all the relevant provisions have been duly complied with. Moreover, he shall also see that the amount of dividend has been properly calculated and accounted for. In this context an auditor must pay due consideration to the following points:

(i) **Examining the Articles of Association** The auditor should examine the Articles of Association of the company to ascertain the differential rights of the shareholders, if any.

(ii) **Verification of Minute Book** The auditor should also examine the minute book of directors' and shareholders' meetings to verify the dividend was properly recommended by the directors and whether it was passed by a resolution in the shareholders' meeting.

(iii) **Computation of Dividend and Identification of Eligible Shareholders** The auditor should verify whether the amount of dividend paid was calculated accurately based on the information of differential rights of the shareholders, paid up value of shares, no. of shares held by shareholders and the rate of dividend approved. He must also verify that only shareholders who are eligible to receive dividend have been issued the dividend warrant.

(iv) **Compliance with Companies Act and Rule**

(a) The auditor must verify that all the relevant provisions of the Companies Act, 2013 regarding declaration and payment of dividend (such as provision for depreciation and past losses, transfer to reserve, etc.) have been duly complied with.

(b) In case the dividend is declared out of past profits or free reserves, he must also see that all requirements under Companies (Declaration and Payment of Dividend) Rules, 2014 have been duly complied with.

**(v) Verifying Transfer of Dividend to Separate Account** Based on the bank statements, the auditor must verify whether the total amount of dividend was transferred to a separate bank account in a scheduled bank within five days from the declaration of such dividend and whether dividend was paid to shareholders only out that account.

**(vi) Vouching the Payment of Dividend** Based on the particulars of Dividend Register, the auditor must verify whether the dividend warrants have been issued to rightful owner. In case of payment through electronic mode (ECS), he must verify from the bank statements that the payment has been properly credited to the account of shareholder.

**(vii) Reconciliation** The auditor shall also reconcile the amount of dividend warrants outstanding with the Dividend Register and the balance in the Bank Account.

**(viii) Timing of Payment** The auditor shall also verify whether sufficient effort was made by the management to distribute the dividend within 30 days from its declaration and shall enquire into all the cases where the dividend could not be paid within such time.

If the auditor comes across any irregularities regarding the above areas, he shall immediately enquire into the matter with the management and if not satisfied, shall also bring such irregularities to the notice of the shareholders.

### 7.8.8 Provisions of Companies Act, 2013 in respect of Unpaid Dividend

The Companies Act, 2013 contains the following provisions in respect of unpaid dividend:

#### A. Transfer of Unpaid Dividend to Separate Account [Section 124(1)]

(i) Where a dividend has been declared by a company but has not been paid to or claimed by any shareholder within thirty days from the date of the declaration of the dividend, the company shall transfer the total amount of unpaid dividend to a special account.

(ii) The transfer shall be made within seven days from the date of expiry of the said period of thirty days.

(iii) The special account, for this purpose, shall be opened by the company in any scheduled bank and will be named as Unpaid Dividend Account.

#### B. Details of Unpaid Dividend to be Published in the Website [Section 124(2)]

Within a period of ninety days of making any transfer of an amount to the Unpaid Dividend Account, the company shall, prepare a statement containing the names, their last known addresses and the unpaid dividend to be paid to each person and place it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose.

### C. Interest to be Paid by the Company in Case of Default [Section 124(3)]

If the company fails to transfer the total amount of unpaid dividend or any part thereof to the Unpaid Dividend Account of the company, it shall pay an interest at the rate of twelve per cent per annum on the amount that has not been transferred to the said account from the date of such default. Such interest will be distributed among the respective shareholders to whom the dividend is unpaid in proportion to the amount remaining unpaid to them.

### D. Payment out of Unpaid Dividend Account [Section 124(4)]

Any person claiming to be entitled to any money transferred under to the Unpaid Dividend Account of the company may apply to the company for payment of the money claimed.

### E. Transfer to Investor Education and Protection Fund [Section 124(5)]

If any money transferred to the Unpaid Dividend Account remains unpaid or unclaimed for a period of seven years from the date of such transfer, it shall be transferred by the company along with interest accrued, if any, thereon to the Investor Education and Protection Fund (IEPF) established by the Central Government u/s 125(1).

### F. Details of Transfer [Section 124(5)]

The company shall send a statement in the prescribed form of the details of such transfer to the authority which administers the said fund and that authority shall issue a receipt to the company as evidence of such transfer.

### G. Obtaining Receipt of Transfer [Section 124(5)]

The company shall obtain a receipt from the authority of the IEPF as evidence of such transfer.

### H. Transfer of Shares [Section 124(6)]

All shares in respect of which dividend has not been paid or claimed for seven consecutive years or more shall be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing the details of such transfer in prescribed form. However, the claimant of shares transferred above shall be entitled to claim the transfer of shares from Investor Education and Protection Fund in accordance with such procedure and on submission of such documents as may be prescribed. Further, in case any dividend is paid or claimed for any year during the said period of seven consecutive years, the share shall not be transferred to Investor Education and Protection Fund.

### I. Penalty for Non-compliance [Section 124(7)]

If a company fails to comply with any of the requirements of Section 124, the company shall be punishable with fine of minimum five lakh rupees and maximum twenty-five lakh rupees. Moreover, every officer of the company who is in default shall be punishable with fine of minimum one lakh rupees and maximum five lakh rupees.

### J. Refund of Unclaimed Dividend from IEPF [Section 125]

Any person claiming to be entitled to any unclaimed dividend may apply to the authority of IEPF constituted under Section 125(5) for the payment of the money claimed.

## 7.8.9 Provisions Relating to Punishment for Failure to Distribute Dividends

Once a dividend is declared, a company must pay such dividend or at least post the warrant in respect thereof to every shareholder entitled to the payment of such dividend within a period of thirty days from the declaration of the dividend.

However, if the company fails to do so, then every director of the company shall, if he is knowingly a party to the default, be punishable with imprisonment which may extend to two years and with fine which shall not be less than one thousand rupees for every day during which such default continues.

Moreover, the company shall be liable to pay simple interest at the rate of eighteen per cent per annum during the period for which such default continues.

However, no offence under this section shall be deemed to have been committed:

(i) where the dividend could not be paid by reason of the operation of any law;

(ii) where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with and the same has been communicated to him;

(iii) where there is a dispute regarding the right to receive the dividend;

(iv) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or

(v) where, for any other reason, the failure to pay the dividend or to post the warrant within the period under this section was not due to any default on the part of the company.

## 7.8.10 Auditor's Duty Regarding Interim Dividend

In connection with the payment of interim dividend, the auditor must consider the following points:

**(i) Examining the Articles of Association** The auditor should examine the Articles of Association of the company to ascertain whether payment of interim dividend is permitted by the articles or not.

**(ii) Verification of Minute Book** The auditor should also examine the minute book of directors' meeting to verify resolution approving the payment of interim dividend.

**(iii) Justification of interim Dividend** The auditor must critically appraise the justification in paying interim dividend. For this purpose –

(a) He shall verify the interim accounts to determine whether profit were really adequate to pay such interim dividend. If interim accounts are not prepared, he shall ask the management to prepare such accounts.

(b) Payment of interim dividend is justified only when there is high chance of earning adequate total profit for the entire year. To verify such probability, the auditor should examine the projected Profit and Loss Statement. In case no such projected statements have been prepared, the auditor should ask the management to prepare such statements.

(c) The auditor shall also enquire whether it is a regular practice of the company to pay interim dividend and if so, what is the average rate of interim dividend. Regular payment of interim dividend at a reasonable rate is always justified.

(d) The auditor must also verify whether the working capital position of the company permits the declaration of interim dividend.

**(iv) Amount of Dividend to be deposited in a Separate Account** The amount of interim dividend shall be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend.

**(v) Vouching the Payment of Dividend** Based on the particulars of Dividend Register, the auditor must verify whether the dividend warrants have been issued to rightful owners. In case of payment through electronic mode (ECS), he must verify from the bank statements that the payment has been properly credited to the account of shareholder.

**(vi) Unpaid Dividend** The auditor should verify the Dividend Register and returned dividend warrants to determine the amount of interim dividend that could not be paid. He shall also to enquire the reason for such dividend remaining unpaid and ensure that the legal requirement, in this context, has been duly complied with.

### 7.8.11 Auditor's Duty Regarding Unpaid Dividend

In connection with the payment of interim dividend, the auditor must consider the following points:

**(i) Statement of Unpaid Dividend** The auditor should collect a statement or list containing every detail regarding the unpaid dividend such as the names of the shareholders, dividend payable to them, dividend warrant number, reason for the dividend remaining unpaid etc.

**(ii) Enquiry** The auditor shall conduct an enquiry to identify whether there was any fault on the part of the company and if so what action has been taken against the company.

**(iii) Verify the Amount of Unpaid Dividend** The auditor shall verify the statement provided by the management in this respect with other supporting documents like Dividend Register, Returned Warrants, bank statement, etc. and shall determine whether the dividend amount has been accurately calculated.

**(iv) Verify the Transfer of Unpaid Dividend to a Separate Account** The auditor shall also verify whether the unpaid dividend has been transferred to a separate account namely Unpaid Dividend Account within seven days from the expiry of 30 days allowed for declaration and payment of dividend.

**(v) Examine the Interest and Fine paid or Payable** In case there is any default on the part of the company to deposit the unpaid dividend within the stipulated time as mentioned above, the company needs to pay interest @ 18% p.a. The auditor must verify whether there is any fault on the part of the company and if so whether they have deposited the interest and the penalty.

**(vi) Publication in the Website** The auditor shall also verify whether the company has published the details of unpaid dividend in its own website and also in other website(s) approved by the government for this purpose.

**(vii) Payment out of Unpaid Dividend Account** In case the company has made any payment during the year from the Unpaid Dividend Account to any shareholder on his application for the same, the auditor must verify that the payment has been made to the right person and the amount so paid is determined properly.

**(viii) Verify the Transfer of Unpaid Dividend to IEPF** In case any amount of dividend is remaining unpaid for more than seven years, the auditor shall verify whether the same along with the interest accrued thereon has been transferred by the company to IEPF. He shall verify the same based on the statement submitted by the company to the IEPF and the receipt issued by the IEPF in this context.

**(ix) Verify the Transfer of Shares to IEPF** The auditor shall also verify whether all the shares in respect of which unpaid dividend has been transferred to IEPF, have also been transferred to such fund.

## 7.8.12 Some Critical Issues on the Allowable Source of Dividend

While declaring dividend, confusion often arises as regards to the eligible source or profit. This is because declaration and payment of dividend is regulated by the provisions of Companies Act and various legal decisions. The question of business prudence also becomes relevant in a few cases. Therefore, in the following section, a number of critical issues are discussed in the light of the above three considerations, as applicable.

### A. Payment of Dividend out of Past Reserves

According to Section 123(1) read with Companies (Declaration and Payment of Dividend) Rules 2014, In the event of inadequacy or absence of profits in any year, a company may declare dividend out of free reserves subject to the fulfillment of the following conditions:

(i) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year:
However, this rule will not be applicable to a company, which has not declared any dividend in each of the three preceding financial years.

(ii) The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(iii) The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(iv) The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid up share capital as appearing in the latest audited financial statement.

(v) No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year. The loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

['Free Reserves' for this purpose shall mean such reserves which are available for distribution as dividend. It shall not include any amount representing unrealised gains, notional gains or revaluation of assets, or any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value.]

Therefore, based on the above discussion, it can be said that subject to fulfillment of a certain conditions a company can pay dividend out of past reserves where current year's profit is inadequate to pay dividend.

It is to be noted in this context that the balance of profit carried forward from previous year is eligible for declaration of dividend without the above restriction provided such balance was arrived at after charging depreciation. Moreover, in case there is a loss in the current year, it must be set off from the above balance before paying dividend.

**B. Payment of Dividend out of Capital Profits**

Any profit arising out of any transaction beyond the normal course of business is known as capital profit. Generally a transaction of capital nature results into such profits. A few instances of capital profit are –

(i) Profit on sale of any fixed assets
(ii) Pre-incorporation profit
(iii) Profit on revaluation of any fixed assets
(iv) Profit on redemption of debenture at a discount
(v) Profit on re-issue of forfeited shares
(vi) Profit on cancellation of own debentures bought from the open market
(vii) Premium received on issue of shares or debentures

Now, the issue of whether capital profits are available for distribution of dividend or not can be discussed as follows.

**I. Judicial Decisions** The judicial pronouncements in this context are given below:

**(i)** ***Lubbock* vs. *The British Bank of South America* (1892)** Here, it was held that if the Articles so authorise, a company can pay dividend out of the profits from sale of a part

of its business provided it is realised in cash. In other words, if permitted by the Articles, a company can pay dividend out of any capital profit realised in cash.

**(ii)** ***West Burn Sugar Refineries Ltd.* vs. *I.R.C* (1960)** Here, it was held that dividend can be paid only out of capital profits realised in cash.

**(iii)** ***Foster* vs. *The New Trinidad Lake Asphalt Co. Ltd.* (1901)** In this case, it was held that a company can pay dividend out of the profit on revaluation of any asset provided such profit remains after revaluation of all assets.

**(iv)** ***Dimbulla Valley Tea Co. Ltd.* vs. *Laurie* (1961)** Here, it was held that a company can issue fully paid bonus shares from any capital profit not realised in cash.

Observing the above decisions, it may be summarised that before making any payment of dividend out of capital profit the following conditions must be fulfilled:

(i) The distribution of capital profit as dividend must be permitted by the Articles.
(ii) Only capital profit realised in cash can be used for this purpose.
(iii) Revaluation profit remaining after revaluation of all assets may also be utilised.
(iv) Before making any dividend payment all revenue and capital losses must be set off from the profits. (*Mills* vs. *Northern Railway of Buenos Aires Co.*)

**II. Provisions of Companies Act** According to Section 123(1) of Companies Act, 2013, a company can declare or pay dividend for any financial year only–

(i) out of current year's profits after providing for depreciation; and/or
(ii) out of the undistributed profits for any previous financial year or years after providing for depreciation; or
(iii) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

It can be seen that in the above provisions, the term 'profit' has not been defined to include only the revenue profit. Therefore capital profit should also be eligible for payment of dividend.

However, in this respect the following points should be given due consideration.

(i) As per Section 52 of the Act, capital profit arising out of issue of shares at a premium should be transferred to Securities Premium Account and should be used only for a few specified purposes mentioned in the Act. Thus dividend cannot be paid out of it.
(ii) As per Companies Act, 2013, profit on re-issue of forfeited shares is to be transferred to Capital Reserve. Hence no dividend should be paid out of it.
(iii) No dividend can be paid out of any pre-incorporation profit as there is no existence of the company prior to its incorporation. So the company, in its capacity of a company cannot generate any profit from commercial operations prior to its incorporation.

**III. Prudent Business Outlook** Capital profit is non-recurring and does not reflect the real profitability of a company. Thus, it is not prudent to pay any dividend out of it. Rather, the profit should be transferred to Capital Reserve and be used to maintain or strengthen the financial stability of the company by setting off capital losses, writing off goodwill or preliminary expenses or discount on issue of debentures or to simply improve the working capital position of the company.

### C. Payment of Dividend out of Capital

Payment of dividend out of capital means payment of dividend out of any asset purchased from the paid up capital. It is basically the return of share capital in disguise, because here a part of the capital is ultimately returned to the shareholders. A few instances of payment of dividend out of capital are –

(i) Payment of dividend from the profit created by showing any revenue expenditure as capital expenditure, providing lower depreciation, creating lower provision for doubtful debt, overvaluing the closing stock, showing fictitious income, etc.

(ii) Payment of dividend from the sale proceeds of any fixed assets.

(iii) Payment of dividend where there is neither any current profit nor any accumulated profit.

Now, the issue of whether capital can be paid as dividend or not, can be discussed as follows.

**I. Judicial Pronouncements** In *Verner* vs. *General and Commercial Investment Trust Ltd*. (1894), it was held that dividend cannot be paid out of capital. If the Memorandum of Association allows such an act, it will be considered as invalid. Consequences of payment of dividend out of capital as upheld in different legal decisions are:

**(i) Oxford Benefit Building Society (1887) and Kingston Cotton Mills Co. (1896)** Here, it was held that if the directors knowingly pay dividend out of capital, they shall be severally and jointly liable to make good the losses arising from such payment.

**(ii) Stringer's case (1869) and Rance's case (1870)** Here, it was held that if the directors depend on the valuation of assets made by the officers and subsequently such valuation proves to be an overvaluation, then they cannot be held liable for payment of dividend out of capital.

**(iii) *Maxham* vs. *Grant* (1900)** In this case it was held that if the shareholders accepts dividend fully knowing that it has been paid out of capital, they have to indemnify the company to the extent of such dividend.

**(iv) *Boaler* vs. *The Watchmakers' Alliance and Others* (1903)** Here, it was held that the directors liability for payment of dividend out of capital will cease if the erosion in capital is replenished by subsequent profit.

**II. Provisions of Companies Act** According to Section 123(1) of Companies Act, 2013, a company can declare or pay dividend for any financial year only–

(i) out of current year's profits after providing for depreciation; and/or
(ii) out of the undistributed profits for any previous financial year or years after providing for depreciation; or
(iii) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

Moreover accumulated profit of the company shall also be eligible for distribution of dividend subject to the conditions specified in Companies (Declaration and Payment of Dividend) Rules 2014.

No other source is legally permitted for payment of dividend. Therefore dividend cannot be paid out of capital. If the directors pay any dividend out capital they will have to indemnify the company to the extent of such dividend.

**III. Prudent Business Outlook** Payment of dividend out of capital amounts to capital erosion which deters the financial health of the company in the long run. It can even risk the winding up of the company. Therefore dividend should never be paid out of capital to protect the interest of the owners as well as all other stakeholders.

**D. Payment of Dividend out of Pre-incorporation Profit**

A company assumes its legal existence only after its incorporation. However, often a company is formed to convert an existing sole proprietorship or partnership business. In such a case all profits of such business prior to the incorporation of the acquiring or new company is called pre-incorporation profit.

A company is not allowed to pay any dividend out of any pre-incorporation profit. This is because prior to its incorporation a company is legally non-existent and hence there cannot arise any question of payment of dividend for a period where the company doesn't even exist.

The arguments that re sited in support of the above proposition are as follows:

(i) Existence of any company is legally not tenable prior to its incorporation.
(ii) Before its existence (i.e. incorporation) a company cannot legally earn any profit.
(iii) The shareholders of any company cannot have any legal claim on pre-incorporation profit as they didn't happen to be the shareholders during such period.

Thus, profit prior to incorporation cannot be used for declaration and payment of any dividend. Rather it can be utilised for the following purposes considering the commercial expediency.

**(i) Payment of Interest on Purchase Consideration** Pre-incorporation profit can be used to write off any interest on the purchase consideration paid from the date of purchase of the business up to the date of incorporation of the company.

**(ii) Writing off any Preliminary Expenses** It can also be used to write off any preliminary expenses incurred at the time of formation of the company.

**(iii) Writing off Goodwill** Any goodwill arising out of business acquisitions can also be written off against the pre-incorporation profit.

**(iv) Transfer to Capital Reserve** Pre-incorporation profit after adjustment of the above items is transferred to Capital Reserve.

### E. Payment of Dividend without Making Good Past Losses

The issue of payment of dividend without making good past losses can be discussed based on the following three considerations.

**I. Judicial Pronouncements** The legal decisions in this respect are as follows:

**(i) *Ammonia Soda Co.* vs. *Arthur Chamberlain & Others* (1918)** In this case, it was held that–

(a) A company may declare dividend without making good the debit balance of Profit and Loss A/c.

(b) After appropriate revaluation, if the value of fixed increases permanently, a company can adjust the debit balance of Profit and Loss A/c from that surplus and can pay dividend from current year's earnings.

**(ii) *Stapley* vs. *Read Bros. Ltd.* (1924)** Here it was held that a company can write up at fair value an asset, which was written off excessively in the earlier years and utilise the sum for writing off the debit balance of Profit and Loss A/c and distribute the current profit as dividend (However the fixed asset referred in this context was the goodwill of the company). Thus writing off past losses is not compulsory for payment of dividend.

**II. Provisions of Companies Act** As per Section 123(1) of Companies Act, 2013 as amended by Section 10 of the Companies (Amendment) Act, 2015, no company shall declare dividend unless carried over previous losses and depreciation not provided in previous year or years are set off against profit of the company for the current year. Therefore, as per this provision, no dividend can be paid without making good past losses.

**III. Prudent Business Outlook** The debit balance of Profit and Loss A/c or the Statement of Profit and Loss is a clear indication that capital has eroded to such extent. Therefore, if the company decides to pay dividend out of current profits without making good such loss, it will fail to maintain its capital even in nominal terms. Further it may also face the threat of extinction in the long run. Therefore, it will always be prudent for the company to set off all past losses before making any dividend payment out of current year's profit.

**F. Payment of Dividend without Making Good Capital Losses**

Capital loss arises due to realisation of any fixed asset at a loss or decline in the value of a fixed asset at the time of revaluation. It doesn't arise in the normal course of business of a company and hence is non-recurring in nature.

Now the issue of payment of dividend without making good capital losses can be discussed based on the following three considerations.

**I. Judicial Pronouncements** The legal decisions in this respect are as follows:

**(i)** ***Bolton* vs. *Natal Land and Colonisation Company Ltd.* (1892)** Here, it was held that in spite of the fact that there was a capital loss resulting into partial erosion of capital and that such loss has not been recovered subsequently, dividend payment out of current profit cannot be denied.

**(ii)** ***Verner* vs. *General and Commercial Investment Trust Ltd.* (1894)** Here, it was held that dividend can surely be paid in this situation. However, the following two reservations must be kept in mind:

(a) If the Articles provide that dividend cannot be paid without making good the capital losses, then such a provision must be adhered to.
(b) Though setting off capital losses is not compulsory, the company must adjust any loss on account of any reduction in value of current assets.

**II. Provisions of Companies Act** The Companies Act, 2013 is silent as to whether capital loss should be adjusted before making any payment of dividend out of current profit. However, as per Section 123(1) of Companies Act, 2013 [as amended by Section 10 of the Companies (Amendment) Act, 2015] read with Rule 3 of Companies (Declaration and Payment of Dividend) Rules 2014, no company shall declare dividend unless carried over previous losses and depreciation not provided in previous year or years are set off against profit of the company for the current year. Since loss may mean revenue as well as capital loss, a company cannot pay dividend without setting off capital losses.

**III. Prudent Business Outlook** Whatever be the legal provision, payment of dividend without making good capital losses is never justified. This is because capital loss results into erosion of capital. Therefore, if this practice is allowed to continue in the long run, it will cause permanent damage to the financial health of the company. Thus considering commercial expediency dividend should be paid only after adjusting capital losses.

## 7.9 DEPRECIATION

### 7.9.1 Meaning of Depreciation

The term 'depreciation' was derived from a latin word 'depretium' where 'de' means decline and 'pretium' means value. Therefore, depreciation, in its dictionary meaning, refers to

reduction in value. A fixed asset gradually loses its potential due to either continuous use or mere passage of time. As a result, the initial amount spent on any asset must be allocated over its entire lifespan to recover such cost from the revenue generated by the use of the asset. In accounting, this systematic allocation of the value of an asset is called depreciation.

According to International Accounting Standard Committee, depreciation is the allocation of the depreciable amount of an asset over its estimated useful life.

As per Ind AS-16, 'Property, Plant and Equipment', depreciation is the systematic allocation of the depreciable amount of an asset over its estimated useful life.

### 7.9.2 Causes of Depreciation

The causes of depreciation can broadly be categorised into Internal Causes and External Causes.

#### A. Internal Causes

These are causes inherent to the nature of the assets. These include–

(i) **Normal Wear and Tear** The service potential of a fixed asset deteriorates with its continuous use. The more an asset is used in the production of goods or rendering services, the more it gets exhausted and requires higher provision for depreciation.

(ii) **Depletion** Depletion also causes depreciation of assets. Wasting assets such as minerals, oil or forest assets lose their value due to continuous extraction of resources.

(iii) **Exhaustion of Working Life** Some assets such as livestock have limited working life. They are depreciated within such period.

#### B. External Causes

These are causes external to the assets. These include–

(i) **Efflux of Time** The lifespan of some assets such as copyright, patent right, etc. is determined by law and hence expires with passage of time even when they are not in use.

(ii) **Obsolescence** Very often technological developments, innovations, etc. makes an asset uneconomical to use and hence, obsolete. In such a case, the asset is discarded and the remaining value is charged against profit as depreciation at a go.

(iii) **Accident** Accidents often damage an asset and significantly hamper its usefulness causing more depreciation charge than before.

### 7.9.3 Objectives of Charging Depreciation

Adequate provision for depreciation is imperative to meet the following objectives:

(i) **Replacement of Asset** Amount charged against profit as depreciation is considered to be the prime source of fund to replace the asset after its useful life.

(ii) **Determination of True Production Cost** Since depreciation is a systematic allocation of cost of an asset over its useful life, such cost should also be included in the cost of production so that it can be recovered from the associated revenue.

(iii) **Determination of Correct Profit** In order to determine the correct profit of an entity all expired costs are to be charged against revenue. Since depreciation is also a cost, it must be charged against revenue to determine profit authentically.

(iv) **True and Fair Presentation** Charging adequate depreciation is essential to determine correct profit and value of fixed asset. Thus true and fair presentation of the financial results and financial state of affairs largely depends on correct estimation of depreciation.

(v) **Preventing Capital Erosion** If depreciation is not provided, profit will be inflated. If dividend is paid out of such inflated profit, it will amount to erosion of capital which, if continued in the long term, may lead to the winding up of the company.

### 7.9.4 Different Methods of Charging Depreciation

The various methods of charging depreciation can broadly be classified into four groups as follows:

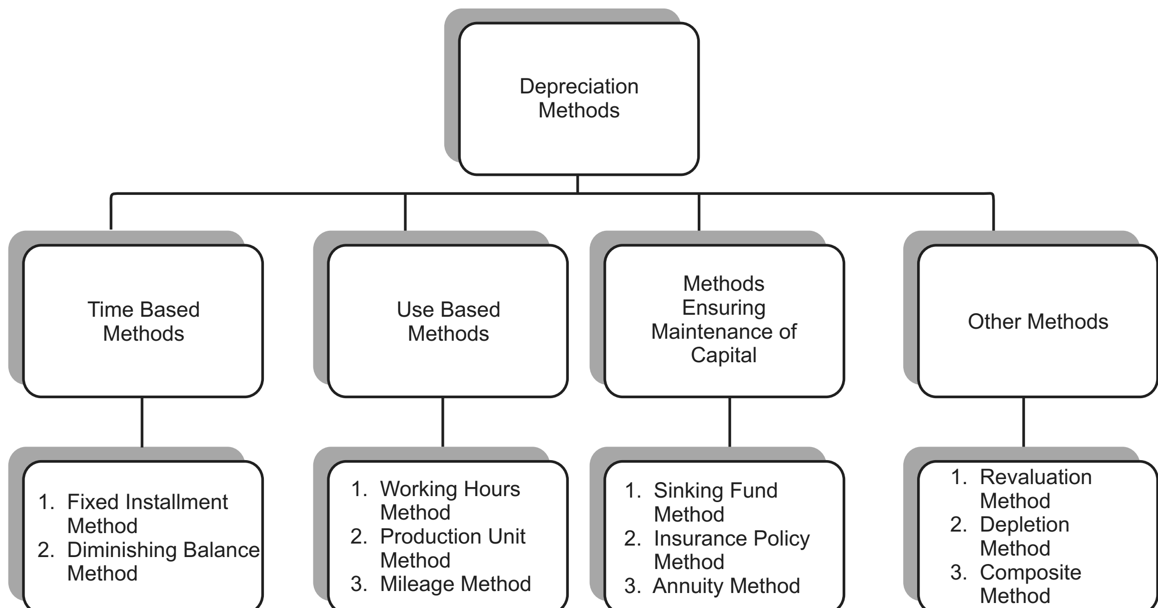


**Fig. 7.1**

The concept and computation methodology of these methods are discussed below:

| Concept of Method | Computational Methodology |
|---|---|
| 1. **Fixed Installment or Straight Line Method:** The depreciable value of the asset is distributed equally over its useful life. | $\text{Depreciation} = \dfrac{\text{Cost of the Asset} - \text{Scrap Value}}{\text{Useful Life}}$ |
| 2. **Reducing or Diminishing Balance Method:** The depreciation is calculated at a fixed percentage of the written down value of the asset. | $r = \left[1 - \sqrt[n]{\dfrac{S}{C}}\right] \times 100$<br>Where, $r$ = rate of depreciation, $S$ = scrap value, $C$ = Cost of the asset, $n$ = Life in years |
| 3. **Working Hours Method:** Here, a machine hour rate is first determined based on the depreciable value and total life in hours. Depreciation is charged for the hours actually worked in a year. | $\text{Machine hour rate} = \dfrac{\text{Cost of the Asset} - \text{Scrap Value}}{\text{Effective life in hours}}$<br>Depreciation p.a. = Machine hour rate × hours worked in a year. |
| 4. **Production Unit Method:** Depreciation is calculated p.u. of production first. Then depreciation charge is calculated based on the total units produced. | $\text{Depreciation p.u.} = \dfrac{\text{Cost of the Asset} - \text{Scrap Value}}{\text{Estimated production in life}}$<br>Depreciation p.a. = Depreciation p.u. × Yearly production |
| 5. **Mileage Method:** Applicable mainly for vehicles. Here, depreciation is calculated per km or per mile. Then depreciation charge is calculated based on the total distance covered. | Depreciation Per Km/Mile<br>$= \dfrac{\text{Cost of the Asset} - \text{Scrap Value}}{\text{Estimated life in km or mile}}$<br>Depreciation p.a. = Depreciation per km or mile × distance covered. |
| 6. **Sinking Fund Method:** Here, depreciation is calculated in such a manner that depreciation amount invested outside at a compounded rate of interest fetches the amount required to recover the total cost of asset. | $A = \dfrac{P}{i}\{(1+i)^n - 1\}$<br>Where, $P$ = Depreciation, $i$ = rate of interest, $n$ = Estimated life in years, $A$ = Total amount required for replacement. |
| 7. **Annuity Method:** Here, depreciation is charged in such a way that depreciation amount over the life accumulates the capital invested in the asset along with the opportunity cost of fund. | $V = \dfrac{A}{i}\left\{1 - \dfrac{1}{(1+i)^n}\right\}$<br>Where $V$ = Present value of asset, $A$ = Annual depreciation, $i$ = rate of interest, $n$ = life of the asset. |
| 8. **Insurance Policy Method:** It is similar to sinking fund method with the exception that the annual amount of depreciation is paid as a premium on an insurance policy, the maturity value of which will recover the proceeds to replace the asset. | Same as Sinking fund method.<br>Where $P$ = Depreciation or premium |

(Contd.)

| | |
|---|---|
| 9. **Revaluation Method:** Here, the asset is valued at the end of each year and depreciation is calculated as the difference between closing value and opening value of asset. | Depreciation = Value of asset at the end of the year– Value of asset at the opening of the year |
| 10. **Depletion Method:** Used in mineral resources, forest resources etc., here depreciation p.u. of the resource is calculated by dividing the value of the resources by the total deposit of resources. Then depreciation charge is calculated for the amount of resources actually extracted. | Value of resources p.u. = Value of resources ÷ total quantity of resources.<br>Depreciation = Value of resources p.u. × quantity of resources extracted. |
| 11. **Composite or Group Method:** Depreciation at a fixed rate is calculated on a group of asset instead of small individual assets. | No depreciation is calculated on individual asset. |

### 7.9.5 Regulatory Framework Regarding Depreciation

In India the regulations in respect of depreciation, especially in company form of organisation has two sources, namely the Companies Act, 2013 with associated Rules and Ind AS-16 on 'Property, Plant and Equipment'.

#### A. Provisions of Companies Act Regarding Depreciation

The provisions of Companies Act, 2013 regarding depreciation are discussed below:

**I. Definition of Important Terms** The following terms have been defined in Schedule II of the Companies Act, 2013.

(i) **Depreciation** Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

(ii) **Depreciable Amount** The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value.

(iii) **Useful Life** The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

**II. Charging Depreciation is Compulsory** According to Section 123(1), a company can declare or pay dividend for any financial year only–

(i) out of current year's profits after providing for depreciation; and/or
(ii) out of the undistributed profits for any previous financial year or years after providing for depreciation.

The depreciation as required above shall be calculated based on the Schedule II of Companies Act, 2013.

**III. Depreciation Includes Amortisation** As per Schedule II, the term depreciation shall include amortisation.

**IV. Useful Life of Asset** Part C of Schedule II has specified useful life of various categories of assets. A company, belonging to such class of companies, as may be prescribed and whose financial statements comply with the accounting standards prescribed under Section 133, shall normally adopt the useful life as stated therein. However, if the company uses a useful life which is different from the useful life as indicated in Part C of Schedule II, it shall disclose the justification for the same.

In respect of all other companies, the useful life of an asset shall not be longer than the useful life that has been prescribed in Part C.

**V. Residual Value** As per Schedule II, the residual value of an asset should generally be not more than 5% of the original cost of the asset. However, companies belonging to a prescribed class of companies for this purpose may use residual value more than 5% of the original cost of the asset, provided they disclose the justification for the same. In respect of all other companies the scrap value of an asset shall not be higher than limit mentioned above.

**VI. Method of Depreciation** Depreciation shall be calculated based on the useful life of the asset as specified in the Schedule and residual value.

**VII. Depreciation on Pro-rata Basis** Where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro-rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed.

**VIII. Disclosure to be Made** The following information shall be disclosed in the accounts, namely,

(i) depreciation methods used; and
(ii) the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule.

**IX. Depreciation for Additional Shift** The useful lives of assets working on shift basis have been specified in the Schedule based on their single shift working. Except for assets in respect of which no extra shift depreciation is permitted (indicated by NESD in Part C above), if an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift, the depreciation shall be calculated on the basis of 100% for that period.

**X. Separate Rate of Depreciation for a Significant Part of Asset** Schedule II has mandated 'Component Approach' for calculation of depreciation. Accordingly, where cost of a part of

the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.

**XI. Separately Notified Asset** The useful life or residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under an Act of Parliament or by the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of this Schedule.

**XII. Asset Pre-existing to Schedule II** From the date the Schedule comes into effect (i.e. 01.04.2014), the carrying amount of the asset as on that date shall be depreciated over the remaining useful life of the asset as per Schedule II.

In case, the remaining useful life of an asset is nil as per this Schedule, the carrying amount of the asset shall be adjusted against the opening balance of retained earnings.

**B. Provisions of Ind AS-16 on 'Property, Plant and Equipment'**

The relevant provisions under Ind AS-16 regarding depreciation are discussed below.

**I. Definition of Important Terms**

(i) **Depreciation** Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

(ii) **Depreciable Amount** Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

(iii) **Residual Value** The residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

(iv) **Cost** Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

(v) **Useful Life** Useful life of an asset is:

   (i) the period over which an asset is expected to be available for use by an entity; or
   (ii) the number of production or similar units expected to be obtained from the asset by an entity.

(vi) **Carrying Amount** Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

**II. Process of Depreciation** Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

However, a significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

**III. Charge of Depreciation** The depreciation charge for each period shall be recognised in profit or loss. However, if the future economic benefits embodied in an asset are absorbed in producing any other assets the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories.

**IV. Depreciable Amount and Depreciation Period**

(i) The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

(ii) The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with Ind AS-8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

(iii) Depreciation is recognised, even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount.

(iv) Repair and maintenance of an asset do not negate the need to depreciate it.

(v) The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

(vi) Depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

(vii) Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

(viii) The useful life of an asset may be shorter than its economic life.

(ix) A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

### 7.9.6 Auditor's Duty Regarding Depreciation

In respect of depreciation charged in the books of accounts of a company, the auditor is expected to perform the following duties:

(i) The auditor should examine that depreciation has been charged at the rates calculated based on the useful life and residual value of the asset as specified in Schedule II.

(ii) The auditor shall also examine that the useful life or residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under an Act of Parliament or by the Central Government, has been applied in calculating the depreciation to be provided for such asset.

(iii) The auditor shall verify whether the method of depreciation has been correctly disclosed in the accounts.

(iv) He should also verify the disclosure regarding the useful life and residual value of the asset with proper explanation for considering higher useful life or scrap value.

(v) The auditor should examine whether depreciation has been accurately calculated on pro-rata basis on any addition, deletion, etc. made during the current year.

(vi) He should also verify whether extra depreciation for the additional shifts have been duly provided for.

(vii) Since no dividend can be paid out of profit without providing for depreciation, the auditor must see whether any such violation has been committed.

(viii) The auditor also needs to verify that depreciation has been correctly accounted for.

(ix) The auditor shall also verify whether the same method of depreciation has been followed over the years. If there appears any change in the method of depreciation, he must enquire the reason for such change and shall satisfy himself with the justification provided by the management. Moreover, the auditor shall also examine whether such a change has been appropriately accounted for.

(x) The auditor must also examine whether the depreciation charge is adequate or not. In case he is not satisfied with the amount of depreciation provided in the books of accounts, he shall ask the management to charge adequate depreciation on assets.

(xi) Finally, the auditor shall also verify that the following information has been disclosed in the financial statements –

  (a) The original cost or any other value in substitute of original cost for each class of assets;
  
  (b) Depreciation provided for each class of assets; and
  
  (c) Accumulated depreciation for each class of assets.

## 7.10 WRITTEN REPRESENTATION BY MANAGEMENT

SA-580, 'Written Representation' provides extensive guidelines in respect of written representation to be obtained by the auditor from the management during the course of audit work. These are as follows:

### 7.10.1 Meaning of 'Written Representation'

As per SA-580, 'written representation' is a written statement by management which is provided to the auditor to confirm certain matters or to support other audit evidence. However, this does not include financial statements, the assertions therein, or supporting books and records.

#### A. Written Representation as Audit Evidence

Audit evidence refers to all the information used by the auditor in arriving at his audit opinion. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, written representations are also audit evidence.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Moreover, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

### 7.10.2 Auditor's Objective in Obtaining Written Representation

The objectives of the auditor are:

(i) To obtain written representations from management that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
(ii) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements; and
(iii) To respond appropriately in case the management and those charged with governance do not provide the written representations requested by the auditor.

### 7.10.3 Written Representations about Management's Responsibilities

#### A. Preparation of the Financial Statements

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework including where relevant their fair presentation.

#### B. Information Provided and Completeness of Transactions

The auditor shall request management to provide a written representation that–

(i) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement, and
(ii) All transactions have been recorded and are reflected in the financial statements.

**C. Description of Management's Responsibilities in the Written Representations**

Management's responsibilities shall be described in the written representations in the manner in which these responsibilities are described in the terms of the audit engagement.

**D. Other Written Representations**

Other SAs may also require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence, the auditor shall request such other written representations.

## 7.10.4 Auditor's Duty about Written Representation

An auditor's duty regarding written representation by the management can be discussed in the following three broad heads:

**A. Doubt as to the Reliability of Written Representations**

If the auditor has concerns about the competence, integrity, ethical values, diligence or commitment of management, he shall determine the effect of such concerns on the reliability of representations (oral or written) and audit evidence in general.

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the management, and shall determine its effect on the reliability of representations (oral or written) and audit evidence in general.

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

**B. Requested Written Representations Not Provided**

If management does not provide one or more of the requested written representations, the auditor shall:

(i) Discuss the matter with the management;
(ii) Re-evaluate the integrity of the management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
(iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

**C. Disclaimer of Opinion**

The auditor shall disclaim an opinion on the financial statements, if

(i) The auditor feels that there is sufficient doubt about the integrity of the management and the written representations are not reliable; or
(ii) Management does not provide the written representations required.

## 7.11 ANNUAL REPORT

The term 'annual report' refers to a well organised and comprehensive report that describes a company's operations and financial conditions throughout the reporting year. Very often, it is a combination of financial and non-financial information in form of different statements along with accompanying narratives that depicts company's activities over the year. In addition, annual report also exhibits company's vision, mission, objectives and values. Annual report is, thus, the medium through which a company communicates with its existing stakeholders and attempts to reach the potential investors.

### 7.11.1 Contents of Annual Report

In India, annual reports are the statutory publications by companies. Accordingly, the contents of an annual report, in India, are largely determined by the prevailing statutes including Companies Act and Rules, requirements by Ministry of Company Affairs, SEBI and other regulators. In addition, since annual reports are the medium of communication with the external stakeholders, often they contain a variety of other information to assist the users in better understand the company. Following are the contents of annual reports of companies in India.

**(i) Chairperson's Report** It is a brief communiqué from the chairperson of the company highlighting the dynamic role of the company in the changing economic and regulatory environment. It generally includes chairperson's observation regarding the economic and industry scenario during the reporting year, his opinion regarding company's operations and the plans for future development of the company.

**(ii) Notice of the Annual General Meeting** The notice contains the date, time and place of the AGM and ordinary and special business to be transacted at the AGM.

**(iii) Report of the Board** As per Section 134 of the Companies Act, 2013, annual report shall include a report from the BOD of the company containing the following:

(a) The extract of the annual return
(b) Number of meetings of the board
(c) Directors' responsibility statement
(d) A statement on declaration given by independent directors
(e) Company's policy on directors' appointment and remuneration
(f) Explanations or comments by the Board on every qualification, reservation or adverse remark or disclaimer made by the auditor in his report; and by the company secretary in practice in his secretarial audit report
(g) Particulars of loans, guarantees or investments
(h) Particulars of contracts or arrangements with related parties
(i) Recommendation for dividend, transfer to reserves
(j) Material changes and commitments, if any, affecting the financial position

(k) Conservation of energy, technology absorption, foreign exchange earnings and outgo
(l) A statement indicating development and implementation of a risk management policy
(m) Details about the policy developed and implemented by the company on corporate social responsibility initiatives
(n) Annual evaluation made by the Board of its own performance and that of its committees and individual directors

**(iv) Management Discussion and Analysis** It is a separate statement by the Board containing various non-financial information about the company and its environment. It mainly discusses the following:

(a) Industry dynamics
(b) Relative position of the company in the industry
(c) Strength, weakness, opportunities and threats
(d) Product and region-wise performance of the company
(e) Internal control system and its adequacy
(f) Risks to which the company is exposed
(g) Future outlook of the company
(h) Operational performance vis-a-vis financial performance
(i) Management and development of human resources

**(v) Corporate Governance Report** In accordance with the requirement of Clause 49 of the Listing Agreement by SEBI, every company is required to include a Corporate Governance Report in its annual report which shall include, among others, the following information:

(a) Company's philosophy on corporate governance
(b) Information about BODs – composition of the board, no. of meetings held, attendance of the directors, etc.
(c) Information about Audit Committee – terms of reference, composition, details of members, meetings and attendance
(d) Information about Remuneration Committee – terms of reference, composition, details of members, remuneration policy, meetings and attendance, details of remuneration
(e) Information about Shareholders' Committee – Details of non-executive director heading the committee, compliance officer and complaints from shareholders
(f) Details of general body meetings
(g) General shareholders' information

As per the Central Government directives, the auditor is to comment whether the company has complied with the corporate governance norms.

**(vi) Auditor's Report on Financial Statements** Annual report also includes the auditor's report on financial statements which, among all other things, shall specifically state –

(a) Whether he has obtained all information necessary to form his opinion.
(b) Whether the company has maintained proper books of accounts.
(c) Whether the financial statements are in agreement with the books of accounts.
(d) Whether the financial statements have complied with the accounting standards notified under Section 133 of Companies Act, 2013.
(e) Whether the Balance Sheet and Statement of Profit and Loss have exhibited true and fair view of the state of affairs and financial performance of the entity for the accounting year.

The report shall also include such other matters as required by the Company (Auditor's Report) Order issued by the Central Government.

**(vii) Financial Statements** Annual report of a company also includes the Balance Sheet and Statement of Profit and Loss to be prepared as per the provisions of Schedule III of Companies Act, 2013 and a Cash Flow Statement to be prepared under Ind AS-7 (previously AS-3).

**(viii) Notes to Accounts** Notes to accounts include the description of various accounting policies, deviations from accounting and auditing standards and other details regarding assets, liabilities, capital, income and expenditure. These are also form an important part of the annual report of a company.

**(ix) Schedules forming part of Balance Sheet and Statement of Profit and Loss** These are the details of various items of Balance Sheet and Statement of Profit and Loss and include Share Capital, Long-term loans and provisions, Short-term loans and provisions, current liabilities, Non-current assets, Current assets, etc. These are also the part of the annual report.

**(x) Business Responsibility Report** Annual reports of top 100 listed companies (in terms of market capitalisation in NSE and BSE) include an additional report on Business Responsibility Report. The report contains company's response towards the nine principles suggested under the 'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business'.

**(xi) Declaration on Corporate Social Responsibility** Annual report shall also include information about the discharge of corporate social responsibility by the company such as the composition of CSR committee, amount and areas of CSR spending.

**(xii) Other Information** Annual report sometimes also includes other non-statutory information such as financial highlights of the company over the years, letters to shareholders, etc.

## 7.12 NEW AREAS UNDER COMPANIES ACT, 2013

### 7.12.1 Audit Committee

Organised corporate frauds have been a reality even since the origin of company form of business and unfortunately many a times such frauds have been committed by the management in collusion with the auditor. As a result, regulators across the world have suggested stringent corporate code of governance. Moreover, a significant part of these codes have been designed to incorporate a number of regulations to ensure auditor's independence, elimination of the scope of any conflict of interest on the part of the auditor as consultant, review of auditor's performance etc. by establishing a separate committee known as Audit Committee.

The concept of audit committee is not new in India. Clause 49 of the Listing Agreement as issued by SEBI had specified such a requirement long ago. However, such a requirement was limited to only listed companies and not for all others.

The new Companies Act, 2013 has broadened the scope further by bringing it in the purview of the Act.

**A. Provisions of Companies Act, 2013 Regarding Audit Committee**

**I. Formation of Audit Committee** As per Section 177(1) read with Companies (Meetings of Board and its Powers) Rules, 2014. The Board of Directors of every listed company and the following classes of companies shall constitute an Audit Committee of the Board:

(i) all public companies with a paid up capital of ten crore rupees or more;
(ii) all public companies having turnover of one hundred crore rupees or more;
(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

**II. Composition** The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority: Moreover, majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand the financial statement [Section 177(2)].

**III. Broad Functions of Audit Committee** As per Section 177(4) of the Act, the Board shall specify, in writing, the terms of reference for the Audit Committee which shall, *inter alia*, include–

(i) The recommendation for appointment, remuneration and terms of appointment of auditors of the company;
(ii) Review and monitor the auditor's independence and performance, and effectiveness of audit process;
(iii) Examination of the financial statement and the auditors' report thereon;
(iv) Approval or any subsequent modification of transactions of the company with related parties;

(v) Scrutiny of inter-corporate loans and investments;
(vi) Valuation of undertakings or assets of the company, wherever it is necessary;
(vii) Evaluation of internal financial controls and risk management systems;
(viii) Monitoring the end use of funds raised through public offers and related matters.

**IV. Committee may ask for Auditor's Comment** The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, the observations of the auditors and review of financial statement before their submission to the Board. The Committee may also discuss any related issues with the internal and statutory auditors and the management of the company [Section 177(5)].

**V. Investigation** The Audit Committee shall have authority to investigate into any matter in relation to the items specified in Section 177(4) or referred to it by the Board. For this purpose, the Committee shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company [Section 177(6)].

**VI. Board's Report and Audit Committee** The Board's report under sub-section (3) of Section 134 shall disclose the composition of an Audit Committee and where the Board had not accepted any recommendation of the Audit Committee, the same shall be disclosed in such report along with the reasons therefor [Section 177(8)].

**VII. Whistle Blowing Policy** Every listed company and company accepting public deposits or borrowing in excess of fifty crore rupees from banks and financial institutions shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed [Section 177(9)].

**VIII. Safeguards against Victimisation** The vigil mechanism under sub-section (9) shall provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases. The company shall disclose establishment of such mechanism on its website, if any, and in the Board's report [Section 177(10)].

## 7.12.2 Corporate Social Responsibility

A business organisation is basically a social entity. It procures its resources from the society and even generates revenue by selling its products to the society. Thus, organisations cannot deny its duty towards the society. However, often corporations, especially the large corporate are found to significantly neglecting this duty towards the society. This is why efforts have been made, at least in last one decade, to bring some mandate in regulatory front to 'force' companies to take up the issue seriously. In line with such initiatives the Companies Act, 2013 has provided detail guidelines in this respect.

### A. Provisions of Companies Act, 2013 regarding Corporate Social Responsibility

The provisions of Companies Act, 2013 regarding CSR are discussed below:

**I. Formation and Composition of CSR Committee** Every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee of the Board consisting of three or more directors, out of which at least one director shall be an independent director.

**II. Board's Report and CSR Committee** The Board's report under sub-section (3) of Section 134 shall disclose the composition of the Corporate Social Responsibility Committee.

**III. Functions of CSR Committee** The Corporate Social Responsibility Committee shall–

(i) formulate and recommend to the Board, a Corporate Social Responsibility Policy which shall indicate the activities to be undertaken by the company as specified in Schedule VII;

(ii) recommend the amount of expenditure to be incurred on the activities referred to in Clause (i); and

(iii) monitor the Corporate Social Responsibility Policy of the company from time to time.

**IV. Board's Responsibility** The Board of every company referred to in sub-section (1) shall–

(i) after taking into account the recommendations made by the Corporate Social Responsibility Committee, approve the Corporate Social Responsibility Policy for the company and disclose contents of such Policy in its report and also place it on the company's website, if any, in such manner as may be prescribed; and

(ii) ensure that the activities as are included in Corporate Social Responsibility Policy of the company are undertaken by the company.

**V. CSR Spending** The Board of every company shall ensure that the company spends, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy.

If the company fails to spend such amount, the Board shall specify the reasons for not spending the amount.

**VI. CSR Activities**

(i) The CSR activities shall be undertaken by the company, as per its stated CSR Policy, as projects or programmes or activities (either new or ongoing), excluding activities undertaken in pursuance of its normal course of business.

(ii) The Board of a company may decide to undertake its CSR activities approved by the CSR Committee, through a registered trust or a registered society or a company established by the company or its holding or subsidiary or associate company or otherwise.

(iii) A company may also collaborate with other companies for undertaking projects or programs or CSR activities.

(iv) The CSR projects or programmes or activities that benefit only the employees of the company and their families shall not be considered as CSR activities in accordance with Section 135 of the Act.

(v) Companies may build CSR capacities of their own personnel as well as those of their Implementing agencies through Institutions with established track records of at least three financial years but such expenditure shall not exceed five per cent of total CSR expenditure of the company in one financial year.

(vi) Contribution of any amount directly or indirectly to any political party shall not be considered as CSR activity.

### 7.12.3 Secretarial Audit

Secretarial Audit is basically a form of compliance audit conducted by the company secretary. Every company needs to comply hundreds of Laws, rules, regulations. These laws are complex and non-compliances would attract major risk to company. Thus an independent appraisal would certainly be of great help to know the extent to which the company has complied with the laws applicable to it and thereby to decide what else should be done to achieve full compliance.

#### Secretarial Audit under Companies Act, 2013

Section 204 [read with Rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014] of the Companies Act 2013 has introduced Secretarial Audit for the following class of companies.

(i) Every listed company;

(ii) Every public company having a paid-up share capital of fifty crore rupees or more; or-

(iii) Every public company having a turnover of two hundred fifty crore rupees or more.

Accordingly the following provisions have been suggested in relation to Secretarial Audit in these companies.

(1) The above companies shall annex with its Board's report made in terms of sub-section (3) of section 134, a secretarial audit report, given by a company secretary in practice, in the format prescribed in Form MR-3 as per Rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014.

(2) It shall be the duty of the company to give all assistance and facilities to the company secretary in practice, for auditing the secretarial and related records of the company.

(3) The Board of Directors, in their report made in terms of sub-section (3) of Section 134, shall explain in full any qualification or observation or other remarks made by the company secretary in practice in his report under sub-section (1).

(4) If a company or any officer of the company or the company secretary in practice, contravenes the provisions of this section, the company, every officer of the company or the company secretary in practice, who is in default, shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

## SUMMARY

- Company audit in India is guided by Companies Act, 2013 (along with all relevant amendments), various Company Rules (along with all relevant amendments), relevant sections of The Chartered Accountants Act, 1949, Accounting Standards notified by Ministry of Corporate Affairs and various Standards of Auditing issued by Institute of Chartered Accountants of India.
- Section 141 of the Companies Act provides the qualifications of a Company Auditor.
- A company auditor is appointed as per the provisions of Section 139 of the Companies Act.
- The Companies Act, 2013 mandated rotation of company auditors.
- The removal of an auditor is subject to Section 140 of the Companies Act.
- The Companies Act, 2013 has largely recognised an auditor as an officer of the company.
- The duties and responsibilities of a company auditor in India is guided by Section 143 of the Companies Act.
- An auditor has both criminal as well as civil liabilities.
- The provisions of Branch Audit have been specified in Section 128(1) of the Companies Act, 2013.
- A statutory auditor is required to incorporate the report of a branch auditor in an appropriate manner in the final audit report.
- Joint audit refers to the system of appointing more than one audit firm or individual chartered accountants to conduct the audit of a single organisation. Big companies with diversified activities often found to appoint several chartered accountants to perform the statutory audit as joint auditors.
- As per the provisions of the Companies Act, 2013, books of accounts can also be maintained under electronic form.
- While evaluating the overall position of a company, often information regarding its various products or services or its operation in different geographical location comes handy. Such information is known as segment information. In India, companies are required to disclose such information as required by Ind AS-108.
- Dividend can largely be defined as the compensation payable to the shareholders for their investment in the company. It is the part of the divisible profit which is actually distributed to the shareholders.

- As per Section 123 of the Companies Act, 2013, dividend can be paid out of current year's profits after providing for depreciation, out of the undistributed profits for any previous financial year or years after providing for depreciation or out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.
- A company auditor has specific duties regarding unclaimed and unpaid dividend.
- Dividend can never be paid out of capital.
- Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life.
- Normal wear and tear, depletion, obsolescence are some of the causes of depreciation.
- Depreciation is charged for determination of correct cost of production, correct profit for replacement of assets and also to prevent capital erosion.
- The regulatory framework for depreciation involves the provisions of Companies Act, 2013 and Ind AS-16.
- While conducting audit, the auditor depends on the written representations by management on a number of occasions.
- The Companies Act, 2013 has introduced a number of new areas or formalised many of the earlier existing provisions on corporate governance including audit committee, secretarial audit and corporate social responsibility.

## EXERCISE

### A. Short Answer Type Questions (2–4 marks)

1. Discuss the qualification of a Company Auditor. [*C.U. B.Com(H), 2013*]
2. Discuss the provisions of Companies Act regarding resignation of an auditor.
3. Discuss the provisions of Companies Act regarding remuneration of an auditor.
4. Discuss the provisions of Companies Act regarding ceiling on the number of audit assignments. [*C.U. B.Com(H), 2015*]
5. Write a short note on Branch Audit.
6. Discuss the responsibilities of a Joint Auditor. [*C.U. B.Com(H), 2013*]
7. List the books of accounts to be kept by a Company as per Companies Act, 2013. [*C.U. B.Com(H), 2014*]
8. State four important matters to be included in a Company's Annual Report.
9. State the provisions of Companies Act regarding payment of dividend out of reserves. [*C.U. B.Com(H), 2013*]
10. Can dividend be paid without writing off past losses? [*C.U. B.Com(H), 2010, 2014*]
11. Can dividend be paid out of capital? Discuss.
12. What is unclaimed dividend as per Companies Act, 2013?

## B. Medium Answer Type Questions (4–6 marks)

1. Discuss the qualification of a Company Auditor as per Chartered Accountants Act, 1949.
2. Discuss the disqualification of a Company Auditor.
3. How a company auditor is removed from his office? [*C.U. B.Com(H), 2011, 2015*]
4. Discuss the status of a company auditor. [*C.U. B.Com(H), 2012*]
5. Discuss the duties of a company auditor. [*C.U. B.Com(H), 2016*]
6. What do you mean by Joint Audit? Discuss the advantages and disadvantages of Joint Audit.
7. What is Segment reporting? Discuss its advantages and disadvantages.
8. Discuss the duties of company auditor regarding segment reporting.
9. What is an Annual report? Discuss the contents of Annual Report.
10. Can dividend be paid out of Capital Profit? Discuss. [*C.U. B.Com(H), 2015*]
11. Discuss the role of a company auditor regarding depreciation.

## C. Essay Type Questions (8–10 marks)

1. Discuss the provisions of Companies Act regarding appointment of a company auditor. [*C.U. B.Com(H), 2014, 2016*]
2. Discuss the rights of a company auditor. [*C.U. B.Com(H), 2012, 2016*]
3. Discuss the liabilities of a company auditor. [*C.U. B.Com(H), 2009*]
4. Discuss the provisions of segment reporting as per Ind AS-108.
5. Discuss the provisions of Companies Act, 2013 regarding Unpaid Dividend. [*C.U. B.Com(H), 2015*]
6. Discuss the provisions of Companies Act, 2013 regarding depreciation.
7. Discuss the provisions of Ind AS-16 regarding depreciation.
8. What do you mean by written representation by management? Discuss the duty of an auditor in this respect.
9. Discuss the provisions of Companies Act, 2013 regarding related party transactions.
10. Discuss the provisions of Ind AS-24 regarding related party transactions.

# 8 CHAPTER

# AUDIT REPORT AND CERTIFICATE

## CHAPTER OUTLINE


**8.1** Introduction
**8.2** Auditor's Report
**8.3** Contents of Audit Report (as per Companies Act and Standards on Auditing)
**8.4** Auditor's Certificate
**8.5** Companies (Auditor's Report) Order 2015 (CARO, 2015)
**8.6** True and Fair View
**8.7** Materiality


**Important Auditing Standards**

- **SA-700 (Revised):** Forming an Opinion and Reporting on Financial Statements
- **SA-705:** Modifications to the Opinion in the Independent Auditor's Report
- **SA-706:** Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

## 8.1 INTRODUCTION

The importance of the report of an auditor needs no exaggeration. It is the audit report through which an auditor communicates with the stakeholders associated with an entity. The concept of materiality plays an important role in forming an opinion of the auditor about the true and fair view of financial statements of a particular period. Audit certificate, on the other hand, guarantees that the matters contained therein are accurate.

## 8.2 AUDITOR'S REPORT

### 8.2.1 Definition

In the words of Lancaster, "A report is a statement of collected and considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of the subject matter of the report."

An audit report is a document written in a standard format through which the auditor expresses his opinion regarding the reliability and correctness of an entity's financial statements. The preparation of audit report is the last work of audit. An auditor presents weaknesses, strengths and details of an organisation through the audit report.

### 8.2.2 Features/Characteristics/Essentials of a Good Audit Report

#### A. Simplicity

A good audit report should be simple so that it can be easily understood by all. A good report is written in a simple language avoiding vague and unclear words. The message of a good report should be self-explanatory.

#### B. Clarity

The report should be clear and unambiguous. Clarity depends on the proper arrangement of facts. The auditor should make his purpose clear, define his sources, state his findings and finally make necessary recommendations.

#### C. Brevity

It should be concise, accurate and specific. It means that a good report is one that transmits maximum information with minimum words. It avoids unnecessary detailing and includes everything which is relevant and required to present proper information.

#### D. Firmness

It should clearly indicate the scope of work to be done. Further, the report should firmly state whether the financial statements of the entity reflect the "true and fair" view of the state of affairs of the business.

#### E. Objectivity

It should be based on objective evidence. Objective evidences facilitate comparison of financial statements with reliability and uniformity. It is very much required to reduce or eliminate biases, prejudices, or subjective evaluations by relying on verifiable data.

#### F. Consistency

Consistency in presenting accounting information should be maintained in a good audit report according to GAAP or IFRS. It is essential for the auditor to verify whether the financial statements for the current period are consistent with the previous financial statements.

#### G. Disclosure

It should disclose all facts and the truth. The auditor has to see whether relevant matters have been properly disclosed as per the regulatory or other requirements.

#### H. Impartiality

It should be unbiased. If recommendations are made at the end of a report, they have to be impartial and objective.

### I. Information-based

Relevant and accurate information should be included in the report. If not so, it will involve unnecessary expenditure and the reports will be a waste. Since decisions are taken on the basis of information contained in the report, any inaccurate information or statistics will lead to wrong decision.

#### J. Timeliness

A report should be prepared and presented within the stipulated time. If the report is presented in time, necessary actions may be taken.

## 8.2.3 Importance

The audit report issued by the auditor is considered as an important informational tool for many parties. Auditor's reports are important to users of financial statements because they inform users of the auditor's opinion as to whether or not the statements are fairly stated or whether no conclusion can be made with regard to the fairness of their presentation. An audit report is of immense use to the following parties or events:

(i) **Shareholders** Audit report helps shareholders or members in understanding how the company is progressing and whether the money they have invested is properly utilised or not.

(ii) **Prospective Investors** Potential investors assess the risk of the company before making any investments. Audit report proves handy in such situation.

(iii) **Suppliers** Creditors are interested in knowing the ability of the company in paying back their dues in time. Audit report serves their purpose.

(iv) **Financial and Lending Institutions** Banks and lending institutions judge the creditworthiness, liquidity position and profitability of the company from the audit report.

(v) **Merger** Whenever potential merger partners need to evaluate a company, they prefer to have statements that have passed a rigorous examination by the auditors.

(vi) **Insurance Claim** In the event of loss of property by fire or other incidents, audit report helps in expediting the process of settlement of claims from the insurance company.

(vii) **Prevention of Wastage** Audit report identifies the wastage which aids management to prevent the recurrence of the same in future.

(viii) **Insolvency** Audit report forms a basis for determining action in cases related to insolvency and bankruptcy.

(ix) **Decision-making** The auditor's report is considered as a trusted informational frame for many financial decisions.

## 8.2.4 Basic Elements of Audit Report

As per **SA-700 "Forming an Opinion and Reporting on Financial Statements",** the basic elements of an audit report are as follows:

### A. Title

In order to differentiate the audit report from other reports (such as the report of the Board of Directors), it is absolutely essential that the auditor's report has an appropriate title, i.e., "Auditor's Report".

### B. Addressee

The Auditor's Report should be appropriately addressed as required by the circumstances of the engagement. Usually, the Auditor's Report is addressed to the appointing authority.

### C. Introductory Paragraph

The introductory paragraph in the auditor's report shall:

(i) Identify the entity whose financial statements have been audited;
(ii) State that the financial statements have been audited;
(iii) Identify the title of each statement that comprises the financial statements;
(iv) Refer to the summary of significant accounting policies and other explanatory information; and
(v) Specify the date of and period covered by each statement comprising the financial statements.

### D. Management's Responsibility for the Financial Statements

(i) In this section of the audit report, it is necessary to describe the responsibilities of those persons who are associated with the preparation of the financial statements of the organisation. However, the use of the word "management" is not mandatory. The audit report should use such term that is appropriate in the context of the legal and regulatory framework applicable to the entity.
(ii) A section with the heading "Management's (or other appropriate terms) Responsibility for the Financial Statements" has to be included in the auditor's report.
(iii) The description of management's responsibility for preparation of the financial statements of the entity shall include an explanation that management is responsible for the preparation of the financial statements according to the applicable financial reporting framework. Further, this responsibility is inclusive of the design, implementation and maintenance of internal control relevant to the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.
(iv) Where the financial statements are prepared according to a fair presentation framework, the explanation of management's responsibility for the financial statements in auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view", as appropriate in the circumstances.

### E. Auditor's Responsibility

A section with the heading "Auditor's Responsibility" has to be included in the auditor's report.

The audit report shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

Further, the auditor's report shall state that the audit was conducted in accordance with the "Standards on Auditing" (SA) issued by the Institute of Chartered Accountants of India (ICAI).

### F. Auditor's Opinion

A section with the heading "Opinion" has to be included in the auditor's report. When expressing an unmodified opinion on the financial statements, the auditor's opinion shall state that the financial statements give a true and fair view.

### G. Other Reporting Responsibilities

If the auditor addresses other reporting responsibilities in addition to the auditor's responsibility under the SAs, a separate section having the subtitle "Report on Other Legal and Regulatory Requirements" has to be included to incorporate those other reporting responsibilities.

### H. Signature of the Auditor

The auditor has to sign the report in his personal name. When a firm is appointed as an auditor, the audit report has to be signed by the auditor in his personal name and in the name of the audit firm as well. The partner or proprietor signing the report has to mention the "Firm Registration Number" and the "Membership Number" assigned by the Institute of Chartered Accountants of India (ICAI).

### I. Date of the Auditor's Report

The date on which the auditor signs the report expressing his opinion on the financial statements of an entity is the date of the auditor's report.

### J. Place of Signature

The auditor's report shall name the place of the specific location where the report is signed.

## 8.2.5 Types of Audit Report

The audit report may be of two types: (1) Unmodified or clean audit report, and (2) Modified audit report.

As per SA-705 "Modifications to the Opinion in the Independent Auditor's Report", modified audit report may be of the following types:

(A) Qualified audit report
(B) Adverse audit report
(C) Audit report with disclaimer of opinion
(D) Piecemeal audit report

### A. Qualified Audit Report

A qualified audit report is one which is submitted when the possible impact of the following on the financial statements are material but not pervasive:

- Material misstatement in financial statements
- Inability on the part of the auditor to obtain sufficient audit evidence

A qualified audit report should **include the basis of qualified opinion**.

#### *Basis for Qualified Opinion*

Some situations leading to a qualified opinion are:

- Non-adherence to AS-2 with regard to inventory valuation at the lower of cost and net realisable value.
- Auditor being prevented by the management from observing the counting of physical inventory where such action is material to the financial statements.

In the case of a qualified audit report, an auditor's opinion should be like this:

> In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the aforesaid financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as on 31st March 20XX, and its profit/loss and its cash flows for the year ended on that date.

### B. Adverse Audit Report

An adverse audit report is one which is submitted when the possible impact of the following on the financial statements are material but not pervasive:

- Material misstatement in financial statements

An adverse audit report should **include the basis of adverse opinion**.

#### *Basis for Adverse Opinion*

Some situations leading to an adverse opinion are:

- Preparing the financial statements on going concern basis even after planning to cease the operation of the company within next six months.

- Serious mis-appropriation of funds committed by the management.

In the case of an adverse audit report, an auditor's opinion should be like this:

> In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 2013 in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31$^{st}$ March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

### C. Audit Report with Disclaimer of Opinion

An audit report with a disclaimer of opinion is one which is submitted when the possible impact of the following on the financial statements are material, but not pervasive:

- Inability on the part of the auditor to obtain sufficient audit evidence

An audit report with a disclaimer of opinion should **include the basis for disclaimer**.

***Basis for Report with Disclaimer of Opinion***

Situations leading to reporting with a disclaimer of opinion are:

- Auditor being prevented by the management from (a) observing the counting of physical inventory and (b) performing other procedures such as requesting external confirmation of debtors and creditors, and bank account balances.

In the case of a report with a disclaimer of opinion, an auditor's opinion should be like this:

> Our responsibility is to express an opinion on these financial statements based on conducting our audit in accordance with the Standards on Auditing under Section 143(10) of the Act. We have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.
>
> **Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.**

### D. Piecemeal Audit Report

When the auditor is not in a position to express his opinion about the entire financial statements of an entity due to the absence of information, he may decide to express an opinion about some of the items contained in the financial statements. Such opinion is called piecemeal opinion and the auditor's report containing such piecemeal opinion is called piecemeal report.

### 8.2.6 Distinction between Clean Audit Report and Qualified Audit Report

| Clean Audit Report | Qualified Audit Report |
|---|---|
| The Auditor submits a clean report when he does not have any reservation with regard to the matters contained in the financial statements. | A qualified audit report is one where an auditor gives his opinion subject to certain reservations. |
| Here, the auditor states that the financial statements give a true and fair view of the state of affairs and results for the period. | The auditor's reservation is generally stated as: "except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company….". |
| There is no specific duty of management for clean reports. | Management has to furnish explanation and full details in respect of each qualification in the auditor's report. |

### 8.2.7 Distinction between Qualified Report and Adverse Report

| Qualified Report | Adverse Report |
|---|---|
| A qualified audit report is one where an auditor gives his opinion subject to certain reservations. | An adverse report is given when the auditor concludes that he does not agree with the affirmations made in the financial statements. |
| The auditor's reservation is generally stated as: "except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date." | Here, the auditor states that "In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date." |

## 8.3 CONTENTS OF AUDIT REPORT (AS PER COMPANIES ACT AND STANDARDS ON AUDITING)

ILLUSTRATION: (Unmodified Opinion on Standalone Financial Statements, Emphasis of Matter Paragraphs, Reporting on Clause 143(3)(i) regarding internal financial controls is required)

ILLUSTRATIVE FORMAT OF INDEPENDENT AUDITOR'S REPORT
ON THE STANDALONE FINANCIAL STATEMENTS OF A COMPANY
UNDER THE COMPANIES ACT, 2013 AND THE RULES THEREUNDER

(Contd.)

***Circumstances include the following***

- Audit of a complete set of standalone general purpose financial statements of a company prepared under the Companies Act, 2013 financial reporting framework.
- The terms of audit engagement reflect description of management's responsibility for the financial statements in SA-210, Agreeing the Terms of Audit Engagement.
- The independent auditor:
  - Has given an **Unmodified Opinion** in respect of true and fair view of the financial statements; and
  - Has given **Emphasis of Matter** paragraphs in respect of:
    - A lawsuit against the Company, the result of which is uncertain.
    - A "material uncertainty" relating to going concern which has been adequately disclosed in the notes to the financial statements.
- In addition to expressing opinion on the true and fair view of the financial statements, **the auditor has other reporting responsibilities required under the Companies Act, 2013 and/or other regulatory requirements, including the responsibility to report on internal financial controls pursuant to Section 143(3)(i) of the Companies Act, 2013.**

**INDEPENDENT AUDITOR'S REPORT**
**TO THE MEMBERS OF ABC COMPANY LIMITED**

**Report on the Standalone Financial Statements**

We have audited the accompanying standalone financial statements of ABC COMPANY LIMITED ("the Company"), which comprise the Balance Sheet as at 31st March, 20XX, the Statement of Profit and Loss, the Cash Flow Statement for the year then ended, and a summary of the significant accounting policies and other explanatory information, [in which are incorporated the Returns for the year ended on that date audited by the branch auditors of the Company's branches at (location of the branches)].

**Management's Responsibility for the Standalone Financial Statements**

The Company's Board of Directors is responsible for the matters stated in Section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for

(Contd.)

ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**

Our responsibility is to express an opinion on these standalone financial statements based on our audit.

We have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.

We conducted our audit in accordance with the Standards on Auditing specified under Section 143(10) of the Act. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal financial control relevant to the Company's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the accounting estimates made by the Company's Directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the standalone financial statements.

**Opinion**

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

**Emphasis of Matters**

We draw attention to the following matters in the Notes to the financial statements:

(i) Note X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the Company by XYZ Company.

(ii) Note Y in the financial statements which indicates that the Company has accumulated losses and its net worth has been fully/substantially eroded, the Company has

(Contd.)

incurred a net loss/net cash loss during the current and previous year(s) and, the Company's current liabilities exceeded its current assets as at the balance sheet date. These conditions, along with other matters set forth in Note Y, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern. However, the financial statements of the Company have been prepared on a going concern basis for the reasons stated in the said Note.

*Our opinion is not modified in respect of these matters.*

**Other Matter**

We did not audit the financial statements/information of________(number) branches included in the standalone financial statements of the Company whose financial statements/ financial information reflect total assets of ₹ ______ as at 31st March, 20XX and total revenues of ₹ _______ for the year ended on that date, as considered in the standalone financial statements. The financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of these branches is based solely on the report of such branch auditors.

*Our opinion is not modified in respect of this matter.*

**Report on Other Legal and Regulatory Requirements**

As required by Section 143(3) of the Act, we report that:

(i) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

(ii) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from the branches not visited by us.]

(iii) The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report.

(iv) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from the branches not visited by us].

(v) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.

(vi) The going concern matter described in sub-paragraph (ii) under the Emphasis of Matters paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

(Contd.)

(vii) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164(2) of the Act.

(viii) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate report in "Annexure A".

(ix) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:

   (a) The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; [or the Company does not have any pending litigations which would impact its financial position.]

   (b) The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts – Refer Note XX to the financial statements; [or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.]

   (c) There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company {or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company}.

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)
Signature
(Xxxxx X. Xxxx)
(Designation)
(Membership No. XXXXX)

Place of Signature:
Date:

### 8.3.1 Applicability of "Emphasis of Matter" Paragraph

The "emphasis of matter" paragraph is required to be included in an auditor's report in the following cases:

- When material misstatement in opening balances is not disclosed.

- When appropriate audit evidences for opening balances are insufficient.
- When a company adopts a new AS early which has a pervasive impact on the financial statements.
- When there is non-provision for contravening applicable laws.
- When non-compliance with Accounting Standards are noticed.
- When there exists an uncertainty as to the future outcome of an exceptional litigation or regulatory action.

### 8.3.2 Important Points on "Emphasis of Matter" Paragraph

- A widespread use of such paragraphs diminishes the effectiveness of an auditor's communication of such matters.
- The inclusion of "emphasis of matter" paragraph in the auditor's report does not affect the auditor's opinion.
- When the auditor includes an "emphasis of matter" paragraph in the auditor's report, it should be included immediately after the "Opinion" paragraph in the auditor's report.

### 8.3.3 Applicability of "Other Matter" Paragraph

The "other matter" paragraph is required to be included in an auditor's report in the following cases:

- The audit of the previous year was conducted by another audit firm.
- The auditor has to report on more than one set of financial statements.
- Restriction has been imposed on the distribution or use of audit report.
- When the effect of scope limitation is pervasive but the auditor is unable to resign from the engagement.

## 8.4 AUDITOR'S CERTIFICATE

### 8.4.1 Definition

An auditor's certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. It means that the person issuing or signing the certificate vouchsafes the truth of the statement made by him. According to Dicksee, a certificate is something that 'makes certain' and is thus necessarily limited to facts capable of absolute verification.

### 8.4.2 Distinction between Auditor's Report and Auditor's Certificate

The main points of difference between audit report and audit certificate are presented below.

| S.No. | Points of Difference | Audit Report | Audit Certificate |
|---|---|---|---|
| 1. | Definition | An audit report is a document written in a standard format through which the auditor expresses his opinion regarding the reliability and correctness of an entity's financial statements. | An auditor's certificate is a written confirmation of the accuracy of the facts stated therein. |
| 2. | Nature | It is an expression of opinion about an entity's financial statements. | It is a confirmation of correctness and accuracy about some matters. |
| 3. | Scope | The scope of the audit report is wide. | The scope of the audit certificate is limited. |
| 4. | Criticism | It may contain constructive criticism. | There is no scope of criticism in audit certificate. |
| 5. | Suggestion | It may contain suggestions or recommendations of the auditor. | There is no scope of suggestions or recommendations in audit certificate. |
| 6. | Basis | Audit report is based on facts, assumptions and estimations. | Audit certificate is based on actual figures and facts. |
| 7. | Guarantee | Audit report is actually an opinion by the auditors and does not guarantee the accuracy of the financial statements. | Audit certificate is a formal statement by the auditors which guarantee the accuracy of the accounts. |
| 8. | Responsibility | Audit report does not hold the auditor responsible for anything wrong in the financial statements. | Audit certificate makes an auditor responsible, if anything stated in the certificate found as untrue later on. |
| 9. | Type/Feature | Audit report is subjective since it is based on opinion. | Audit certificate is objective as it is based on facts. |
| 10. | Format | Audit report has to be presented in the prescribed format. | Audit certificate is not required to be presented in any standard format in most of the cases. |

## 8.5 COMPANIES (AUDITOR'S REPORT) ORDER 2015 (CARO, 2015)

### 8.5.1 Notification

The Ministry of Corporate Affairs, Government of India notified CARO on 10th April 2015.

### 8.5.2 Applicability

It shall apply to every company including a foreign company except

(i) A banking company as defined in Clause (c) of Section 5 of the Banking Regulation Act, 1949.

(ii) An insurance company as defined under the Insurance Act, 1938.
(iii) A company licensed to operate under Section 8 of the Companies Act.
(iv) A One Person Company as defined under Clause 62 of Section 2 of the Companies Act.
(v) A small company as defined under Clause 85 of Section 2 of the Companies Act.
(vi) A private limited company with a paid up capital and reserves not more than ₹ 50 lakh and which does not have loan outstanding exceeding ₹ 25 lakh from any bank or financial institution and does not have a turnover exceeding ₹ 5 crore at any point of time during the financial year.

### 8.5.3 Matters to be Included in Auditor's Report

#### A. Fixed Assets

(i) Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets.
(ii) Whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.

#### B. Loans

Whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under Section 189 of the New Act. If so,

(i) Whether receipt of the principal amount and interest are also regular; and
(ii) If overdue amount is more than 1 lakh rupees, whether reasonable steps have been taken by the company for recovery of the principal and interest.

#### C. Internal Control

Is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services? Whether there is a continuing failure to correct major weaknesses in internal control system.

#### D. Orders Passed by Courts or Tribunals

(i) Is the company regular in depositing undisputed statutory dues including provident fund, employees'state insurance, income tax, sales tax, wealth tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities? And if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.
(ii) In case dues of income tax or sales tax or wealth tax or service tax or duty of customs or duty of excise or value added tax or cess have not been deposited on account of any

dispute, then the amount involved and the forum where dispute is pending shall be mentioned (A mere representation to the concerned department shall not constitute a dispute).

(iii) Whether the amount required to be transferred to investor education and protection fund in accordance with the relevant provisions of the Companies Act, 1956 (1 of 1956) and rules made thereunder has been transferred to such fund within time.

**E. Inventory**

(i) Whether physical verification of inventory has been conducted at reasonable intervals by the management.

(ii) Are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported.

(iii) Whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account.

**F. Acceptance of Deposits from Public**

In case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of Sections 73 to 76 or any other relevant provisions of the New Act and the rules framed thereunder, where applicable, have been complied with? If not, the nature of contraventions should be stated. If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

**G. Maintenance of Cost Records**

Where maintenance of cost records has been specified by the Central Government under sub-section (l) of Section 148 of the New Act, whether such accounts and records have been made and maintained.

**H. Accumulated Losses**

Whether in case of a company which has been registered for a period not less than 5 years, its accumulated losses at the end of the financial year are not less than 50% of its net worth and whether it has incurred cash losses in such financial year and in the financial year immediately preceding such financial year also.

**I. Default in Repayment of Dues to Bank or Financial Institutions**

Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported.

**J. Guarantee for Loans Taken by Others**

Whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company.

**K. Term Loans**

Whether term loans were applied for the purpose for which the loans were obtained.

**L. Reporting of Fraud**

Whether any fraud on or by the company has been noticed or reported during the year. If yes, nature and the amount involved is to be indicated.

## 8.6 TRUE AND FAIR VIEW

### 8.6.1 Concept

The Companies Act, 1913 used the term "true and correct". It was subsequently replaced by the term "true and fair" in the Companies Act, 1956. Thus both the terms have some legal connotation. Still there exist a huge debate and controversy over the use of the term"true and fair", as both the terms are subjective, at least to some extent, and require the auditor to apply his judgement.

The term "true and fair" is an opinion and not a guarantee. It is the principle which is widely used in auditing and financial accounting. "True and fair view" in auditing means that the financial statements are free from material misstatements and faithfully represent the financial performance and position of the entity. The expression of true and fair view is, however, not strictly defined in the accounting literature, in the Companies Act or in a legal notion. As such, its interpretation leaves much room for flexibility. In general terms, "true" denotes that financial statements are factually correct and have been prepared according to the applicable reporting framework such as the IFRS and they do not contain any material misstatements that may mislead the users. On the other hand, "fair" implies that the financial statements present the information faithfully without any element of bias and they reflect the economic substance of transactions rather than just their legal form.

Preparation of true and fair financial statements has been expressly recognised as one of the responsibilities of the directors of companies in the corporate law of several countries such as in the Companies Act, 2006 in the UK. Company law of certain jurisdictions requires the auditors to expressly state in their audit report whether in their opinion the financial statements present a true and fair view of the financial performance and position of the entity.

### 8.6.2 Guiding Factors

The guiding factors of "true and fair view" are as follows:

(i) Material information has been properly disclosed.

(ii) In preparing the financial statements of an entity, generally accepted accounting principles have been strictly adhered to.
(iii) Financial statements of the entity have been prepared in accordance with regulatory requirements.
(iv) Disclosure of exceptional and non-recurring items have been properly made.
(v) Due care has been taken in dealing with the events occurring after the balance sheet date but prior to the submission of the audit report.
(vi) The information contained in the financial statements are ambiguous.
(vii) Financial statements are drawn up in such a manner that there is no overstatements or understatements. At the same time, there is no window dressing or secret reserve.

## 8.7 MATERIALITY

### 8.7.1 Concept

The concept of "materiality" implies that trivial matters are to be disregarded, and all important matters are to be disclosed. Materiality is the threshold or cut-off point above which missing or incorrect information in financial statements is considered to have an impact on the decision-making of users. As per SA-320 (Revised) "Materiality in Planning and Performing an Audit", misstatements, including omissions, are considered to be material if they, individually or in an aggregate, could reasonably be expected to influence the economic decisions of the users taken on the basis of the financial statements. Judgements about materiality are made in the light of surrounding circumstances. What is material in one circumstance may be quite immaterial in another circumstance. Further, the judgements about materiality are also affected by the size or nature of a misstatement or a combination of both. Both the amount (quantity) and nature (quality) of misstatements are significant in deciding what is material.

### 8.7.2 Relevance

According to AICPA, the auditor's determination of materiality is a matter of professional judgment. It is affected by the auditor's perception of the financial information needs of users of the financial statements. The concept of materiality is applied by the auditor both in planning and performing the audit. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. But the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence when evaluating their effect on the financial statements. The materiality constitutes an indispensable element in the decisional process of the financial audit.

The report of the auditor whereby he expresses his opinion about the reliability and correctness of financial statements depends very much on the degree of materiality. If the auditor has not noticed any material misstatements or deficiencies he submits an unmodified report. Otherwise, the report is a modified one. The modified report may take the form of a qualified report, if material misstatements or deficiencies are observed but the same are not

pervasive. On the other hand, if misstatements or deficiencies are significant the auditor has to submit an adverse report or a report with disclaimer of opinion.

### 8.7.3 Determining/Judging Materiality

Materiality is a relative term. What may be material in one circumstance may be immaterial in another. The consideration of materiality is the matter of professional judgement and experience of the auditor. There are no hard and fast rules that can be followed in all situations to determine materiality.

The following points have to be considered carefully in determining whether an item is material or not:

(i) **Nature of Transaction** The nature of the transaction is an important factor. For example, if a transaction of a small amount is occurring unusually, it may be material, but if it is a routine transaction, it may be immaterial.

(ii) **Size or Amount of Transaction** The size or amount involved is another significant criterion. For instance, ₹ 1000 may be material to a small concern whereas it may be immaterial to a large concern.

(iii) **Judging an Item Individually and in Aggregate** In judging materiality, an item should be considered separately as well as in aggregate. For example, an item may be immaterial separately, but it may be material when it is aggregated with many immaterial items. When this occurs, the effect becomes material.

(iv) **Relative Significance** To judge the materiality of an item, its relative significance may be considered. If an item belongs to a group, it should be considered in relation to that group and not in isolation. For instance, a particular item of a current asset or current liability may be viewed on the basis of total current assets or total current liabilities.

(v) **Comparison with Previous year's Figures** The materiality of an item can be considered by comparing it with the corresponding figure in the previous year. For example, if the amount of an item of the current year is very low or high while comparing it with the corresponding figure in the previous year, then it may become material when compared to the corresponding figure of the previous year.

(vi) **Impact of Prior Period Items** In prior periods, misstatements may have been considered immaterial and may have been ignored accordingly. Such misstatements may affect the financial information of the current period.

(vii) **Precise Calculation vs. Estimation** Even a small error is material, if such error results from the amount of an item which has been determined precisely and objectively. But if the amount of an item is subject to estimation, a minor difference from the estimate may be viewed as immaterial.

(viii) **Deviation from Statutory Requirement** Deviation from regulatory requirement is often treated as material even if the amount of deviation is minor.

## SUMMARY

- An audit report is a document written in a standard format through which the auditor expresses his opinion regarding the reliability and correctness of an entity's financial statements.
- A good audit report should be simple, clear, concise, firm, based on objective evidence, consistent, unbiased and it should disclose all material facts in time.
- Auditor's reports are important to users of financial statements because they inform users of the auditor's opinion as to whether or not the statements are fairly stated.
- The basic elements of an audit report are title, name of the addressee, introductory paragraph, paragraph on management's responsibility for the financial statements, paragraph on "Auditor's Responsibility", paragraph on "Auditor's Opinion", signature of the auditor, the place of his signature, and the date of signing the audit report.
- The audit report may be of two types: (1) Unmodified or clean audit report, and (2) Modified audit report. As per SA-705 "Modifications to the Opinion in the Independent Auditor's Report", modified audit report may be of three types: qualified audit report, adverse audit report, and audit report with a disclaimer of opinion.
- An auditor's certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The scope of the audit certificate is limited in comparison to the audit report.
- The Ministry of Corporate Affairs, Government of India notified Companies (Auditor's Report) Order 2015 (CARO, 2015) on 10th April 2015.
- "True and fair view" in auditing means that the financial statements are free from material misstatements and faithfully represent the financial performance and position of the entity.
- The concept of "materiality" implies that trivial matters are to be disregarded, and all important matters are to be disclosed. Materiality is the threshold or cut-off point above which missing or incorrect information in financial statements is considered to have an impact on the decision-making of users.
- The auditor's determination of materiality is a matter of professional judgment. Materiality is a relative term. What may be material in one circumstance may be immaterial in another.

## EXERCISE

### A. Short Answer Type Questions (2–4 marks)

1. What is audit report?
2. Give definition of certificate. [*C.U. B.Com(G), 2016*]

3. What is audit certificate?
4. What are the different types of audit report? [*C.U. B.Com(G), 2016*]
5. What do you mean by unmodified audit report?
6. What is meant by qualified audit report?
7. What is an adverse or negative audit report? [*C.U. B.Com(H), 2016*]
8. What is a report with a disclaimer of opinion?
9. What is piecemeal report? [*C.U. B.Com(G), 2016*]
10. When was CARO 2015 notified and by whom?
11. When an auditor gives an adverse report? [*C.U. B.Com(G), 2016*]
12. What are the purposes for which auditor's certificate is required? [*C.U. B.Com(G), 2012*]
13. Mention any four types of audit report. [*C.U. B.Com(G), 2013*]

## B. Medium Answer Type Questions (4–6 marks)

1. Distinguish between audit report and audit certificate. [*C.U. B.Com(H), 2013, 2016; C.U. B.Com(G), 2012*]
2. What is unqualified audit report? [*C.U. B.Com(H), 2016*]
3. State the significance of audit report.
4. Classify modified audit report.
5. What are the different types of audit report? [*C.U. B.Com(G), 2013*]
6. Discuss in brief the concept of "true and fair view".
7. Discuss, in brief, the concept of "materiality".
8. Explain the relevance of the term "materiality" with regard to audit.
9. Discuss the factors to be considered while judging materiality at the time of audit of an organisation. [*C.U. B.Com(H), 2013*]
10. State four important matters included in a company auditor's report. [*C.U. B.Com(H), 2013*]
11. How should an auditor give his opinion in a qualified audit report?
12. How should an auditor give his opinion in an adverse audit report?
13. How should an auditor give his opinion in a report with a disclaimer of opinion?
14. Point out the essential of a good audit report? [*C.U. B.Com(H), 2016*]
15. Give a specimen of qualified report.
16. State the determining factors when an auditor is to give adverse or negative report instead of giving a qualified report. [*C.U. B.Com(H), 2014*]
17. State the circumstances under which "other matter" paragraph have to be included in an audit report.
18. Mention the circumstances under which "emphasis of matter" paragraph has to be included in an audit report.

19. Which companies are kept outside the purview of CARO, 2015?
20. Is there any provision of the Companies Act to establish true and fair view of the financial statement of a company? Also, mention four guiding factors to establish true and fair view of the financial statement. [*C.U. B.Com(H), 2014*]
21. How can one determine whether an item is material or not?
22. Distinguish between a qualified report and an adverse report.
23. Distinguish between a clean report and a qualified report.
24. Write short notes on:
    (a) True and Fair view
    (b) Qualified Audit Report
    (c) Concept of Materiality [*C.U. B.Com(G), 2012*]
25. Discuss the contents of an Audit Report in brief. [*C.U. B.Com(H), 2014*]
26. State the provisions of the Companies Act regarding contents of audit report. [*C.U. B.Com(H), 2012, 2014*]
27. Explain the concept of meteriality. Discuss the factors to be considered while judging the metariality at the time of audit of an organisation. [*C.U. B.Com(H), 2013*]

## C. Essay Type Questions (8–10 marks)

1. Give a specimen of an unmodified audit report.
2. Explain the essential elements of an audit report.
3. Describe the essentials of a good audit report.
4. Discuss the matters to be reported under CARO-2015.
5. Is there any provision of the Companies Act to establish true and fair view of the financial statements of a company? Also mention guiding factors to establish true and fair view of the financial statements. [*C.U. B.Com(H), 2014*]

# 9 CHAPTER
# AUDIT OF DIFFERENT INSTITUTIONS

**CHAPTER OUTLINE**

- **9.1** Introduction
- **9.2** Bank Audit
- **9.3** Legislations Relevant to Audit of Banks
- **9.4** Approach to Bank Audit
- **9.5** Audit of Banks—Provisions, Procedure, Internal Control
- **9.6** Non-Performing Assets
- **9.7** Long Form Audit Report of Banks
- **9.8** Audit of Insurance Companies
- **9.9** Audit of Educational Institutions
- **9.10** Audit of Cooperative Societies
- **9.11** Audit of Hospital and Nursing Home
- **9.12** Audit of a Club
- **9.13** Audit of Hotel and Restaurant
- **9.14** Audit of Cinema Hall
- **9.15** Audit of Public Library
- **9.16** Government Audit
- **9.17** Audit of Local Body or Local Self Government
- **9.18** Audit of Non-Profit Seeking Organisations (NGOs)
- **9.19** Comptroller and Auditor General of India

## 9.1 INTRODUCTION

An efficient financial system requires transparent and effective financial institutions for its growth and development. So, it is necessary to conduct audit of banks, insurance companies by the auditor as per the provisions of different Acts, Rules and Regulations. Educational institutions and hospitals are required to audit to maintain their integrity and utilisation of public

funds. Local bodies and non-profit seeking organisations (including NGOs) are collecting funds from different sources as well as perform development and social activities. They are required to submit their audit report to funding agencies. Comptroller and Auditor General of India play a pivotal role to make audit of different government organisations and point out loopholes of the system.

## 9.2 BANK AUDIT

Banking is a dynamic activity which has constantly been undergoing a change. In recent years, there has been a remarkable change in the nature, volume and spread of transactions of banks. Apart from this, the non-traditional functions of banks, e.g., foreign exchange activities, merchant banking, portfolio management and investment etc., have acquired considerable importance during this period. Another significant development from the view point of auditing is the issuance detailed guidelines regarding income recognition, asset classification, provisioning and other related matters, by the Reserve Bank of India.

### 9.2.1 Legislation Relevant to Annual Accounts of Banks

The provisions of the Banking Regulations Act, 1949 relating to the annual accounts of a banking company are discussed in Section 29 which are as follows:

(i) **Preparation of Annual Accounts** Banks have to prepare a balance sheet and a profit and loss account at the end of each year, i.e., 31$^{st}$ March in the forms set out in the Third Schedule of the Act. A foreign bank has to prepare similarly a balance sheet and a profit and loss account every year in respect of business transacted through its business in India.

(ii) **Signature of Financial Statements** As per Section 29(2) of the said Act, the balance sheet and profit and loss account of a banking company incorporated in India shall be signed by the manager or the principal officer of the company and where there are more than three Directors of the company by at least three of those Directors or where there are not more than three Directors, by all the Directors. In case of a banking company incorporated outside India, the balance sheet and profit and loss account shall be signed by the manager or agent of the principal officer of the company in India.

(iii) **Applicability of Companies Act, 2013** In the case of banking companies (but not in the case of banks other than banking companies), the provisions of the Companies Act, 2013, relating to the balance sheet and profit and loss account are also applicable to the extent they are not inconsistent with the requirements of the Banking Regulation Act, 1949.

(iv) **Format of Balance Sheet** As per the Third Schedule of the Banking Regulation Act, 1949, main items of balance sheet and profit and loss account are shown below:

**Balance Sheet**

| Capital and Liabilities | Assets |
|---|---|
| 1. Capital (Schedule - 1)<br>2. Reserves and Surplus (Schedule - 2)<br>3. Deposits (Schedule - 3)<br>4. Borrowings (Schedule - 4)<br>5. Other Liabilities and Provisions (Schedule - 5) | 1. Cash and Balances with Reserve Bank of India (Schedule - 6)<br>2. Balances with Banks and money at call and short notice (Schedule - 7)<br>3. Investments (Schedule - 8)<br>4. Advances (Schedule - 9)<br>5. Fixed Assets (Schedule - 10)<br>6. Other Assets (Schedule - 11) |

Besides the above, contingent liabilities and bills for collection are required to disclose according to (Schedule - 12).

**Profit and Loss Account**

| Expenditure | Income |
|---|---|
| 1. Interest Expended (Schedule - 14)<br>(i) Interest on deposits<br>(ii) Interest on Reserve Bank of India/Inter-bank borrowings<br>2. Operating Expenses (Schedule - 15)<br>(i) Payments to and provisions for employees<br>(ii) Rent, taxes and lighting<br>(iii) Printing and stationery<br>(iv) Advertisement and publicity<br>(v) Depreciation on Bank's property<br>(vi) Director's fees, allowances and expenses<br>(vii) Auditors' fees and expenses<br>(Including branch auditors)<br>(viii) Law charges<br>(ix) Postages, Telegrams, Telephones, etc.<br>(x) Repairs and maintenance<br>(xi) Insurance | 1. Interest Earned (Schedule - 12)<br>(i) Interest/discount on advance/bills<br>(ii) Income on investments<br>(iii) Interest on balances with Reserve Bank of India and other inter-bank funds<br>2. Other Income (Schedule - 13)<br>(i) Commission, exchange and brokerage<br>(ii) Profit on sale of investments<br>(iii) Profit on revaluation of investments<br>(iv) Profit on exchange transactions<br>(v) Profit on sale of land, buildings and other assets<br>(vi) Income earned by way of dividends, etc. from subsidiaries/companies and/or joint ventures abroad/in India |

## 9.3 LEGISLATIONS RELEVANT TO AUDIT OF BANKS

The principal enactments which govern the functioning of various types of banks are:

**(i) Reserve Bank of India Act, 1934** The Reserve Bank of India Act, 1934 is the legislative act under which the Reserve Bank of India was formed. The objectives of the Act are: (a) regulate the issue of bank notes (b) for keeping reserves to ensure stability in the

monetary system (c) to operate effectively the nation's currency and credit system. The Act covers: (i) the constitution (ii) powers (iii) functions of the Reserve Bank of India.

(ii) **Banking Regulation Act, 1949** The Banking Regulation Act, 1949 regulates all banking companies in India. This Act was applicable only to banking companies. But, in 1965, it was amended to make it applicable to cooperative banks and to introduce other changes. The Act gives the Reserve Bank of India the power to license banks.

(iii) **State Bank of India Act, 1955** The State Bank of India Act, 1955 constituted the State Bank of India for the purpose of taking over the undertaking and business of the Imperial Bank of India. The Imperial Bank of India was founded in 1921 under the Imperial Bank of India Act, 1920.

(iv) **Companies Act, 2013** The Companies Act, 2013 regulates incorporation of a company, responsibilities of a company, directors and dissolution of a company. The 2013 Act is divided into 29 chapters containing 470 sections as against 658 sections in the Companies Act, 1956 and has 7 schedules. The Act has replaced the Companies Act, 1956.

(v) **State Bank of India (Subsidiary Banks) Act, 1959** The State Bank of India (Subsidiary Banks) Act, 1959 provided for the formation of certain Government or Government associated banks as subsidiaries of the State Bank of India.

(vi) **Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970** The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 enacted for the acquisition and transfer of the undertakings of certain banking companies, having regard to their size, resources, coverage and organisation, in order to control the heights of the economy and to meet progressively, and serve better, the needs of development of the economy in conformity with national policy.

(vii) **Regional Rural Banks Act, 1976** The Regional Rural Banks Act was passed in 1976 to set up regional rural banks with a view to provide sufficient banking and credit facility for agriculture and other rural sectors. The area of operation of Regional Rural Banks (RRBs) is limited to the area as notified by the Government of India, covering one or more districts in the State.

(viii) **Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980** This Act is to provide for the acquisition and transfer of the undertakings of certain banking companies, having regard to their size, resources, coverage and organisation, in order to control the heights of the economy and to meet progressively, and serve better, the needs of development of the economy in conformity with national policy and objectives and for matter connected therewith or incidental thereto.

(ix) **Information Technology Act, 2000** The Information of Technology Act, 2000 provides legal framework for electronic governance by giving recognition to electronic records and digital signatures.

**(x) Prevention of Money Laundering Act, 2002** The Prevention of Money Laundering Act, 2002 is enacted to prevent money laundering and to provide for confiscation of property derived from money-laundering.

**(xi) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002** The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, empower the bank to possess the securities of defaulting borrower. Banks can now take possession of the assets from borrower and convert the same in Security Receipts.

**(xii) Credit Information Companies (Regulation) Act, 2005** The Credit Information Companies (Regulation) Act, 2005 is enacted to regulate the actions of credit information companies in India and to facilitate efficient distribution of credit as well as for matters connected to the same.

**(xiii) Payment and Settlement Systems Act, 2007** The Payment and Settlement Systems Act, 2007 provides for the regulation and supervision of payment systems in India and designates the Reserve Bank of India (RBI) as the authority for that purpose and all related matters.

## 9.4 APPROACH TO BANK AUDIT

The Guidance Note on Audit of Banks issued by the Institute of Chartered Accountants of India in 1994 and subsequently revised by the Institute time to time (last revised in 2016). This Guidance Note recognises that the general approach to audit of banks involves:

**(i) Preliminary Work** The auditor should acquire sound knowledge of laws relating to banking companies. He should also acquire knowledge of the services offered by the bank and operating procedures followed in a bank. The auditor should have a sufficient knowledge of the books of accounts maintained by the bank, other reports also.

**(ii) Evaluation of Internal Control System** The auditor should evaluate the internal control system of a bank before undertaking the audit work. Internal control system is the total system of control which ensures safeguarding of assets, adherence to policies, procedures, authenticity of accounting data. So, evaluation of internal control system prevailing in the bank is essential to ensure reliability on accounting data.

**(iii) Substantive Testing** Substantive testing procedure should be adopted by the auditor to check whether there is any fraud or error in the financial statements. The auditor adopts substantive testing to detect material misstatements in financial statements if any, so as to express an opinion regarding true and fair view of the financial statements.

**(iv) Finalisation of Report** After completion of the total audit work, auditor prepares and finalises the report expressing an opinion regarding the true and fair view of the financial statements.

The auditor has to take into consideration the following special characteristics of banks.

(i) **Volume of Transactions** The volume of transactions in a bank is very large. As transactions are repetitive in nature and follow a well laid down process of summarisation and grouping.

(ii) **Cash or Cash Equivalents** Banks deal with large volumes of cash or equivalents like negotiable instruments and, therefore, normally have well designed internal control procedures which have evolved after a good deal of experimentation over the years.

(iii) **More Number of Branches** Banks operate through a wide network of branches and, therefore, they have a large number of branch auditors.

(iv) **Off-Balance Sheet Items** Banks often assume significant commitments without any transfer of funds which ultimately result in off-balance sheet items.

(v) **Regulations** The functioning of banks is regulated by different Acts, Regulations and Authorities. Such regulations influence accounting and auditing aspects also.

(vi) **Audit** Bank audit is a time-framed programme. The objective of bank audit is to express opinion on the truth and fairness of balance sheet items and profit and loss of the bank. The transactions of a bank are primarily related to accepting of deposits and providing of loans. Bank audit aims at verification of the deposits held by confirmation from depositors and advances made by obtaining confirmation from borrowers.

## 9.5 AUDIT OF BANKS—PROVISIONS, PROCEDURE, INTERNAL CONTROL

### 9.5.1 Provisions relating to Audit of Banks

According to Section 30 of the Banking Regulation Act, 1949, a banking company must get its balance sheet and profit & loss account duly audited by the statutory auditor. The legal provisions of bank audit are discussed below:

#### A. Audit of Accounts

The Balance Sheet and Profit & Loss account shall be audited by a chartered accountant. The appointment, duties and power of an auditor is governed by the Companies Act, 2013.

(i) **Eligibility of Auditor** The auditor has to be a person who is qualified to act as an auditor of a company under Section 141 of the Companies Act, 2013 and who does not attract any disqualification as per Rule 10 of the Audit and Auditors Rules, 2014.

(ii) **Appointment of Auditor** A banking company appoints its auditor in the Annual General Meeting with the prior approval of the Reserve Bank of India. A nationalised bank is required to appoint an auditor for audit of financial statements with the prior approval of the Reserve Bank of India by the Board of Directors. The auditor of State Bank of India is appointed by the Comptroller and Auditor General (CAG) of India in consultation with the Central Government. An auditor of subsidiaries of State Bank of India is appointed by the State Bank of India. In case of Regional Rural Banks (RRBs),

the auditor is appointed with the approval of the Central Government by the Board of Directors of the concerned bank. The appointment of auditor of Cooperative Banks is governed by the relevant Cooperative Societies Act.

(iii) **Remuneration of Auditor** The remuneration of the auditor of a banking company is fixed as per Section 197 of the Companies Act, 2013. In case of nationalised banks and State Bank of India, the remuneration of auditor is determined by the Reserve Bank of India in consultation with the Central Government. The RRBs fix remuneration of the auditor as per their own norms with the prior approval of the Central Government.

(iv) **Powers of the Auditor** The auditor of a bank enjoys the same power as those of a company auditor as per the Companies Act, 2013, except that the powers of the auditor of a cooperative bank.

**B. Filing of Accounts**

Banks shall submit the auditor's report along with the Balance Sheet and Profit & Loss Account to the Reserve Bank of India within three months from the end of the year.

### 9.5.2 Procedure for Conducting Bank Audit

The procedures for conducting audit of a banking company are as follows:

**A. Evaluation of Internal Control System**

To evaluate internal control system, the auditor can make auditing in depth in respect of certain transactions. Check and test its actual working.

**B. Checking of Advances**

The auditor should check that there exists an effective internal control system in various areas of credit management. He also checks that the advance is in the balance sheet fairly in its realisable value and income generated by the advance is properly recognised.

**C. Verify Major Items of Assets**

The auditor should check in respect of various assets:

(i) **Physical Verification of Cash Balances** Physical verification of cash should be conducted by the auditor on a suitable date as close to the balance sheet date.

(ii) **Balance with Reserve Bank of India** The auditor should ensure that the bank maintains minimum cash reserve as required by the RBI.

(iii) **Balances with other Banks** The auditor should check balances with other banks are recorded properly.

(iv) **Money at Call and Short Notice** The auditor should ensure that these types of short-term investments have been made as per the guidelines of the head office of the bank. He should also verify investment certificates and interest accrued thereon.

(v) **Ownership of Investment and Valuation of Investment** The auditor should verify the ledger balance with confirmation certificate from the RBI. He should also confirm that the investment of surplus funds is made, following the guidelines properly and that the investments have been made in Government securities, debentures, bonds through proper procedure.

(vi) **Loans and Advances** The auditor will examine loans and advances sanctioned and disbursed as per the guidelines and approval of the competent authority. Necessary documents and creditworthiness of the borrower must be checked by the auditor.

(vii) **Valuation of Fixed Assets** Auditor will physically verify fixed assets of banks and check whether proper depreciation is charged or not as per the Companies Act and Income Tax Act.

### D. Checking of Liabilities

The auditor should check the following liabilities:

(i) **Capital** The auditor should ensure that legal requirements such as capital are compiled by the bank. He should see that the reserve fund is created as per Section 17 of the Banking Regulation Act, 1949.

(ii) **Deposits** The auditor should check balance of each category of deposit accounts like savings, current, term and recurring deposits and should ensure that the system of crediting interest to different accounts as per norms.

(iii) **Borrowings** Auditor should verify borrowings with reference to necessary documents such as agreements, correspondences, etc. He also ensures that borrowings have been properly authorised.

(iv) **Accrued Interest** Auditor should check interest on different deposits and borrowings credited to customers accounts as per the existing terms and conditions.

(v) **Provisions** Provisions for income tax, doubtful debts, depreciation in securities, and dividend are made as per the respective acts, rules and regulations.

(vi) **Other Liabilities** Auditor should also examine other liabilities of banks such as bills payable, etc.

(vii) **Contingent Liabilities** Auditor should check details of material claims against the bank and check proper internal control over those transactions.

### E. Verification of Profit and Loss Account

The auditor should confirm that all items of profit and loss account pertains to the bank and relevant to that accounting period only. He should also ensure that all necessary adjustments of accrued, prepaid and outstanding items have been properly made.

### F. Making Audit Report

After examination of the books of accounts the auditor places the audit report expressing an opinion regarding the true and fair view of the financial statements of the banking company.

## 9.5.3 Internal Control Evaluation of Banks

Good internal check and control are pre-requisite in the operating system of a bank. A system of effective control is a critical component of bank management and a foundation for the safe and sound operation of banking organisations. A system of strong internal controls can help to ensure that the goals and objectives of a banking organisation will be met and the bank will achieve long-term profitability targets, and maintain reliable financial and managerial reporting.

In today's environment, the banks use different applications to carry out different transactions which may include data flow from one application to other application, the auditor while designing his plans should also understand interface controls between the various applications.

Before making an audit of a bank evaluation of the design and actual operation of the internal control system is important. The general scheme of internal controls in a bank is discussed below:

### A. Division of Work and Rotation of Duties

The auditor should see the following in respect of division of work and rotation of duties:

(i) Every bank has detailed policy on delegation of powers. The financial and administrative powers of each committee/each official/each position are communicated to all persons concerned. The auditor should examine whether the powers and authorities of various officers are well defined and commensurate with their status and responsibilities or not.

(ii) The auditor should also check the work is so arranged that no transactions are complete unless the work of one person is checked by another.

(iii) The auditor will check that employees are rotated from one duty to another duty without any prior intimation.

### B. Accounting Procedures

Internal control system in connection with accounting procedures are as follows:

(i) The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not. The auditor should evaluate the accounting procedures of banks to assess whether or not the ledgers and other books of accounts are kept up-to-date.

(ii) The auditor may seek to identify the significant flow of the transactions and significant application systems that are relevant to the accounting process.

(iii) The auditor should examine that the system of sanctioning loans and advances is in order and it safeguards the interest of banks.

**C. Maintaining Assets of Customers**

The auditor should check that ownership of shares, bonds and other financial assets taken as securities is transferred in the name of the bank and effective control of such securities are maintained. The auditor should see that assets like jewellery, certificates and other valuables are kept in joint custody of designated and responsible officers.

## 9.6 NON-PERFORMING ASSETS

### 9.6.1 Concept

The Reserve Bank of India has issued a number of circulars relating to classification of advances, creation of provision for bad and doubtful advances, recognition of interest income on doubtful advances of banks. Advances of banks are classified into two categories, i.e., **standard and non-performing**. An advance which does not disclose any problems and does not carry more than the normal risk is associated to the banking business is called standard assets. A non-performing asset is also an advance other than a standard asset.

An asset, including a leased asset, becomes non-performing when it ceases to generate income for a bank.

Different kinds of credit facilities, treated as performing or non-performing, are discussed below:

**(i) Term Loans** A term loan is treated as a non-performing asset (NPA), if interest and/or installment of principal remain overdue for a period of more than 90 days.

**(ii) Cash Credits and Overdrafts** A cash credit or overdraft account is treated as NPA, if it remains out of order as indicated above.

**(iii) Bills Purchased and Discounted** Bills purchased and discounted are treated as NPA, if they remain overdue and unpaid for a period of more than 90 days.

**(iv) Securitisation** The asset is to be treated as NPA, if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

**(v) Agricultural Advances** A loan granted for short duration crops will betreated as NPA, if the installment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for one crop season.

**(vi) Credit Card Accounts** Credit card account will be treated as non-performing asset, if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the next statement date. The gap between two statements should not be more than a month. It is further suggested by the RBI that banks should follow this uniform

method of determining over-due status for credit card accounts while reporting to credit information companies and for the purpose of levying of penal charges, viz., late payment charges, etc., if any.

### 9.6.2 Types of Non-Performing Assets (NPA)

NPAs may be classified into Sub-standard, Doubtful and Loss assets.

#### A. Sub-standard Assets

Sub-standard assets are those assets which has remained NPA for a period less than or equal to 12 months (with effect from 31$^{st}$ March, 2005). In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the bank in full.

#### B. Doubtful Assets

An asset would be classified as doubtful, if it has remained in the sub-standard category for a period of 12 months (with effect from 31$^{st}$ March, 2005). Doubtful assets has added characteristics besides the characteristics of sub-standard assets that the weaknesses make collection or liquidation in full on the basis of currently known facts, conditions and values highly questionable and improbable.

#### C. Loss Assets

Loss assets are those assets which have been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off. As per the RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value."

### 9.6.3 Non-Performing Assets—Provisions

A non-performing asset has a two-fold impact on the profitability of a bank. First, the bank ceases to earn income on this asset which is legitimate income and secondly, the bank is required to make provisions for these assets.

The banks should make provision against sub-standard assets, doubtful assets and loss assets as below:

#### A. Loss Assets

Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.

#### B. Doubtful Assets

(i) 100 per cent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.

(ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25 per cent to 100 per cent of the secured portion depending upon the period for which the asset has remained doubtful.

| Period for which the advance has remained in 'doubtful' category | Provision requirement (%) |
|---|---|
| Up to one year | 25 |
| One to three years | 40 |
| More than three years | 100 |

**C. Sub-standard Assets**

As per the RBI guidelines, a general provision of 15 per cent on the total outstanding should be made without making any allowance for ECGC guarantee cover and securities available. The 'unsecured exposures' which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent on the outstanding balance.

However, in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as sub-standard will attract a provisioning of 20 per cent instead of the aforesaid prescription of 25 per cent.

## 9.7 LONG FORM AUDIT REPORT OF BANKS

The main audit report of a bank is to be submitted as per the requirements of the Banking Regulations Act, 1949. The statutory audit report doesn't represent all the functioning of a bank. So, the RBI has issued a notification by which bank auditor has to issue an additional report which is known as Long Form Audit Report (LFAR) in addition to statutory audit report. Apart from furnishing the main audit report of the financial statements, the auditor of a nationalised bank, State Bank of India, private banks and foreign banks have also to prepare a Long Form Audit Report.

So, the Long Form Audit Report is a separate report to be submitted to the management, in the format prescribed by the RBI. The latest format of LFAR has been revised in the year 2003 and was made effective from 31st March, 2003. The Guidance Notes on Audit of Banks issued by the Institute of Chartered Accountants of India deals with Long Form Audit Report. The LFAR highlights certain important aspects of the working of the banks such as internal control system, accounting policies, profitability and financial position.

(i) **Internal Control System** The status of internal control system and procedure of banks have not been kept pace with the rapid expansion of branches and with the qualitative changes in the nature of business and risks of banks.

(ii) **Accounting Policies** The accounting policies followed by banks, especially those relating to bad and doubtful advances, valuation of investments and other securities, have changed significantly over the years. These aspects should be reflected in the LFAR.

**(iii) Profitability** The auditor is expected to analyse variations in major items of income and expenditure and important ratios. He may comment on the extent of income generated through non-traditional and special activities and unusual items which had significantly impact on the profit/loss for the year of a bank.

**(iv) Financial Position** The auditor after examining the books of accounts maintained by the bank should draw a conclusion regarding the true and fair view of the financial statements.

### 9.7.1 Contents of Long Form Audit Report (LFAR)

In a LFAR there is a detailed questionnaire formulated by the RBI contains the matters required to be reported by the Branch Auditors on system and controls. This form has one main questionnaire which is applicable to all branches and other is additional questionnaire for specialised branches and also one annexure in respect of large/ irregular/ critical advances.

Mainly the questionnaire in this format is divided into five parts, viz., Capital, Liabilities, Assets, Profit & Loss Account, and General.

**(i) Capital** Capital of a bank comprises of share capital from government, member societies and individual and share holding of government in the total capital. The auditor has to verify all the points in relation to capital, changes made in opening and closing capital.

**(ii) Liabilities** Liabilities include deposits from various persons, loan taken from RBI and other banks, contingent liabilities and other liabilities. Auditor has to examine whether loans are repaid on time or not, interest calculated on loan is proper or not, etc.

**(iii) Assets** Assets of a bank includes advances given to various persons, cash balance, investments, balance with RBI and other banks, money at call or short notice and other assets. Auditor has to verify that whether receipt of principal and interest are regular or not, whether cash balance is up to the limit or not, etc.

**(iv) Profit & Loss Account** This account includes interest income, facility related income, interest expense, various charges, etc. Auditor has to check whether interest income and expenses are properly calculated at appropriate rate or not, whether all the incomes and expenses are provided for or not, etc.

**(v) General** In general the miscellaneous points are included like inter-branch accounts, proper books of accounts, appropriate controls, adequate internal control, etc. Auditor has to verify whether proper books of accounts are kept or not, whether appropriate controls are placed or not, etc.

## 9.8 AUDIT OF INSURANCE COMPANIES

Insurance companies carrying on any types of insurance business were governed by the Insurance Act, 1938. This Act was the first legislation enacted to regulate the conduct of insurance companies in India. This Act, as amended from time to time, continues to be in force. The Life Insurance Corporation Act was passed on 1st July 1956 and the Life Insurance Corporation of India began to function from 1st September 1956. Subsequently, the General Insurance Business Nationalisation Act in 1972 and formed the General Insurance Corporation of India. The Insurance Regulatory & Development Act, (IRDAI) passed in 1999 and private players are doing insurance business from 2000.

### 9.8.1 Features of Accounting System of Insurance Companies

The main features of accounting system of insurance companies as per the IRDA guidelines are given below:

**(i) Applicability of Accounting Standards** Every Balance Sheet, Receipts and Payments Account [Cash Flow Statement] and Profit and Loss Account [Shareholders' Account] of the insurer shall be in conformity with the Accounting Standards (AS) issued by the Institute of Chartered Accountants of India (ICAI) to the extent applicable to the insurers carrying on insurance business.

**(ii) Premium** Premium shall be recognised as the income over the contract period or the period of risk, whichever is appropriate. Unearned premium as well as premium received in advance, both of which represent premium income not relating to the current accounting period, shall be disclosed separately in the financial statements.

**(iii) Premium Deficiency** Premium deficiency shall be recognised, if the sum of expected claim costs, related expenses and maintenance costs exceeds related unearned premiums. For contracts exceeding four years, once a premium deficiency has occurred, future changes to the liability shall be based on actuarial/technical evaluation.

**(iv) Acquisition Costs** Acquisition costs, if any, shall be expensed in the period in which they are incurred. Acquisition costs are those costs that vary with, and are primarily related to, the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e., commencement of risk).

**(v) Claims** The components of the ultimate cost of claims to an insurer comprise the claims under policies and claims settlement costs. Claims under policies comprise the claims made for losses incurred, and those estimated or anticipated under the policies. A liability for outstanding claims shall be brought to account in respect of both direct business and inward reinsurance business.

**(vi) Procedure to Determine the Value of Investments** An insurer shall determine the values of investments in the following manner:

(a) *Real Estate-Investment Property* Investment property shall be measured at historical cost less accumulated depreciation and impairment loss, residual value being considered zero and no revaluation being permissible. The insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred. An impairment loss shall be recognised as an expense in the Revenue/ Profit and Loss Account immediately. Fair value as at the balance sheet date and the basis of its determination shall be disclosed in the financial statements as additional information.

(b) *Debt Securities* Debt securities including government securities and redeemable preference shares shall be considered as "held to maturity" securities and shall be measured at historical cost subject to amortisation.

(c) *Equity Securities and Derivative Instruments that are traded in Active Markets* Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value as at the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price of the stock exchanges where the securities are listed shall be taken.

**(vii) Loans** Loans shall be measured at historical cost subject to impairment provisions. The insurer shall assess the quality of its loan assets and shall provide for impairment.

### 9.8.2 Legislation Relevant to Audit of Insurance Companies

The auditor should know the various Acts, Rules, Regulations, Relevant notifications governing the insurance industry. He also should look into the important aspects arising out of those which might have an effect on determination of nature, timing and extent of audit procedures while performing his role as an auditor.

The primary legislations which deal with the insurance business in India are the Insurance Act, 1938 and the Insurance Regulatory and Development Authority Act, 1999. Various Acts and Regulations are:

#### A. Insurance Act, 1938

The Insurance Act, 1938 is enacted to regulate the insurance sector in India. It provides the broad legal framework within which the industry operates.

#### B. Life Insurance Corporation Act, 1956

Over 245 insurance companies and provident societies were merged to create the state-owned Life Insurance Corporation in 1956.

#### C. General Insurance Business Nationalisation Act, 1972

The Government of India nationalised 107 companies by enacting the General Insurance Business Nationalisation Act in 1972 and formed the General Insurance Corporation of India.

### D. Insurance Regulatory and Development Authority Act, 1999 (IRDA Act, 1999)

The Insurance Regulatory & Development Act, 1999 (IRDAI) formed the Insurance Regulatory and Development Authority of India (IRDAI) in April 2000 which is a statutory regulatory body both for life, non-life and health insurance industry.

The objectives of IRDA are: (i) To promote the interest and rights of policy holders; (ii) To promote and ensure the growth of Insurance Industry; (iii) To ensure speedy settlement of genuine claims and to prevent frauds and malpractices and (iv) To bring transparency and orderly conduct of in financial markets dealing with insurance.

### E. Companies Act, 2013

Some provisions of the Companies Act, 2013 are also applicable to insurance industry.

## 9.8.3 Review of Internal Control of Insurance Companies

The statutory auditor should review the internal control of insurance companies in the following ways:

(i) **Underwriting** The main objective of an internal control system for underwriting is adherence to guidelines for acceptances of insurance, proper recording of insurance risk and its evaluation. The auditor should review the underwriting function which comprises of examination of applications for insurance, the rating of risks and the establishment of premiums.

(ii) **Premium** Premium is the consideration received by an insurer from the insured under an insurance contract. In this contract, insurer agrees to undertake certain sum of risk on behalf of the insured. The auditor should ensure that correct premium is calculated and collected before acceptance of any risk. Again the premium is accounted for in an appropriate manner and that the premium is collected only in respect of such risks which are assumed by the insurance company.

(iii) **Commission** Commission is payable for getting the insurance business. The internal control in respect to commission is aimed at ensuring that commission is paid in accordance with the rules and regulations of the insurance company and as per the agreement with the agent.

(iv) **Reinsurance** The auditor will check reinsurance transactions which involve determination of correct amount for reinsurance ceded, proper valuation of assets and liabilities arising out of reinsurance transactions and adherence to legal provisions, regulations and reinsurance agreements.

(v) **Claims** Cost of claims includes all expenses incurred in settlement of claims. The auditor should ensure that only bonafied claims are paid. He will also check proper recording and disclosing of cost of claims in the financial statements.

### 9.8.4 Audit Procedure of Insurance Companies

The following aspects are to be considered in case of audit of insurance companies:

(i) **Review of Internal Control** The auditor should review the internal control system of insurance companies to ensure its effectiveness.

(ii) **Receipts of Premium** The auditor should check the premium receipts with the insurance policies, cover notes, policy register, etc. Since premium is the main source of income of an insurance company, so it should be carefully checked with the necessary supporting documents.

(iii) **Verification of Cancelled Policies** The auditor should ensure that the policies against which no premium has been received, stand cancelled.

(iv) **Accounting Treatment of Premium** The auditor should see that the proper adjustments have been made for outstanding premium, premium received in advance and ensure that the premium due on or before balance sheet date whether received or not have been properly accounted for.

(v) **Accounting Treatment of Claims** The auditor should ensure that claim account have been debited by proper amount, provisions for unsettled claims have been made, average clause have been applied for under insurance, provisions are less than the amount of insurance, etc.

(vi) **Payment of Commissions** The auditor should see that commissions have been paid to the agents as per rules and regulations and the treatment for outstanding commission has been properly made.

(vii) **Income from Investment** The auditor should see that income from investments have been properly accounted for. He should also see that year-end valuation of investment has been properly made.

(viii) **Remuneration of Employees** The auditor should see that employees' remuneration have been properly accounted for. He also ensures that reimbursement of other expenses has been debited against proper head.

(ix) **Management Expenses** The auditor should see that management expenses incurred have been authorised by competent authority.

(x) **Interest and Bank Charges** The auditor should see that interest and bank charges have been properly accounted for.

### 9.8.5 Audit Report of Insurance Companies (Matters as per IRDA)

The IRDA issued the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations in 2000. An insurer carrying on life insurance business, after the commencement of these Regulations,

shall comply with the requirements of Schedule A. An insurer carrying on general insurance business, after the commencement of these Regulations, shall comply with the requirements of Schedule B. Schedule A and Schedule B deal with accounting principles for preparation of financial statements, disclosures forming part of financial statements, general instructions for preparation of financial statements, contents of management report and preparation of financial statements. The report of the auditors on the financial statements of every insurer and reinsurer shall be in conformity with the requirements of Schedule C, or as near as thereto as the circumstances permit.

The report of the auditors on the financial statements of every insurer is discussed below:

**A. Examination of Books of Accounts**

(i) Auditors should obtain all the information and explanations which, to the best of their knowledge and belief were necessary for the purposes of their audit and whether they have found them satisfactory;

(ii) Auditors should check whether proper books of account have been maintained by the insurer so far as appears from an examination of those books.

(iii) Auditors should examine whether proper returns, audited or unaudited, from branches and other offices have been received and whether they were adequate for the purpose of audit.

(iv) Auditors should check whether the Balance Sheet, Revenue Account and Profit and Loss Account dealt with by the report and the Receipts and Payments Account are in agreement with the books of account and return.

(v) Auditor should verify whether the actuarial valuation of liabilities is duly certified by the appointed actuary including to the effect that the assumptions for such valuation are in accordance with the guidelines and norms, if any, issued by the Authority, and/or the Actuarial Society of India in concurrence with the Authority.

**B. The Auditors shall express their opinion on whether**

(i) the balance sheet gives a true and fair view of the insurer's affairs as at the end of the financial year/period;

(ii) the revenue account gives a true and fair view of the surplus or the deficit for the financial year/period;

(iii) the profit and loss account gives a true and fair view of the profit or loss for the financial year/period;

(iv) the receipts and payments account gives a true and fair view of the receipts and payments for the financial year/period.

(v) the financial statements are prepared in accordance with the requirements of the Insurance Act, 1938 (4 of 1938), the Insurance Regulatory and Development Act, 1999 (41 of 1999) and the Companies Act, 2013 to the extent applicable and in the manner so required.

(vi) the investments have been valued in accordance with the provisions of the Act and these Regulations.

(vii) the accounting policies selected by the insurer are appropriate and are in compliance with the applicable accounting standards and with the accounting principles, as prescribed in these Regulations or any order or direction issued by the Authority in this behalf.

**C. The Auditors shall further certify that**

(i) they have reviewed the management report and there is no apparent mistake or material inconsistencies with the financial statements;

(ii) the insurer has complied with the terms and conditions of the registration stipulated by the Authority.

**D. A certificate signed by the auditors (which shall be in addition to any other certificate or report which is required by law to be given with respect to the balance sheet) certifying that**

(i) they have verified the cash balances and the securities relating to the insurer's loans, reversions and life interests (in the case of life insurers) and investments;

(ii) to what extent, if any, they have verified the investments and transactions relating to any trusts undertaken by the insurer as trustee; and

(iii) no part of the assets of the policyholders' funds has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 (4 of 1938) relating to the application and investments of the policyholders' funds.

## 9.9 AUDIT OF EDUCATIONAL INSTITUTIONS

Educational institutions are also non-profit seeking concern. The methods of keeping accounts of different institutions like, schools, colleges, universities, etc. are almost same. The auditor must be aware of such accounting systems before vouching the documents.

**(i) Constitution** The auditor should go through Trust deed, Regulations, Acts and statutes in respect of universities. Auditor must have knowledge about the different Act, Rules and Regulations of concerned institutes as the provisions affecting accounts.

**(ii) Minutes Book** Auditor should carefully examine notices and minutes of the meeting of Governing Body, Senate, Syndicate, Court and Council and other committees which affect the accounts and finance of the institutes. He should confirm that the decisions undertaken are duly complied with for operation of bank accounts, approval of expenditure.

**(iii) Budget** The auditor must check out the budget allocated on different heads and activities of the institutes.

**(iv) Verification of Transactions Related to Receipts** Auditor should verify the following:

(a) Collections of fees on different heads from students according to their classes and session must be verified with the cash book.
(b) Any arrear or old fees on account of fees, fines, etc. should be taken into consideration at the end of each period.
(c) Advance fees received are also to be noted accordingly.
(d) Library fees or late fine imposed by the institutes should be recorded separately.
(e) Collection and payments made on account of students' hostel must be checked properly.
(f) Grants received from Government or other organisations.
(g) Donations received, if any, to be acknowledged and be recorded properly in the account.
(h) Rent received from the let out property, if any, be checked accordingly.

**(v) Verification of Transactions Related to Payments** Auditor should check and examine the following:

(a) Determine the operation of internal control system over the various heads expenditure.
(b) Honorarium to the resource persons or external experts.
(c) Capital and revenue expenditure should be vouched separately.
(d) Caution deposit from the students to be refunded as per record in the register.
(e) Payment of various expenses should be verified with the proper vouchers.
(f) Purchase of fixed assets and IT related products must be checked physically.
(g) Allocation of fund for purchase of books and other library materials and its proper utilisation are required to verify.
(h) Payment of Salaries to staff and wages for casual labour to be checked at the end of the year.
(i) Payment for hostel maintenance, if any.
(j) Any financial aids given to the students.

**(vi) Employees Benefit Funds** The amount of Provident Fund received from the employees must be checked and verified.

**(vii) Maintenance of Different Registers** Auditor should ensure proper maintenance of stock registers, asset registers for furniture, stationeries, computers and other IT equipment, etc.

**(viii) Depreciation** Auditor should verify the amount of depreciation charged on different fixed assets, books, etc.

**(ix) Taxation** Auditor should verify tax exemptions under Income Tax Act and TDS has been deducted from the salaries of the staff and deposited to the proper authorities.

(x) **Financial Information** Auditor should verify the form and manner of presenting financial information comply with the account standards and applicable legal requirements.

(xi) **Certificates** Auditor should get appropriate representation of management and certificates with respect to various aspects covered during the audit.

## 9.10 AUDIT OF COOPERATIVE SOCIETIES

The auditor of a co-operative is appointed by the Registrar of Cooperative Societies. Audit procedures of a cooperative society are as follows:

(i) **Constitution** The auditor should study the Cooperative Societies Act, 1912, and rules and regulations as far as they concern the accounts. In case such an Act has been replaced by state legislation, examine the provisions of such a special legislation.

(ii) **Share Capital** He should check that a member does not hold more than 20 per cent of the share capital of the society or shares of the society worth more than ₹ 1,000 as mentioned in Section 5 of the Cooperative Societies Act, in case of the liability of members limited by shares.

(iii) **Cash Receipt** The auditor should vouch the receipt of cash on account of deposits with the cash book.

(iv) **Loans to Members** The auditor should examine the loans granted with agreements. Loans can be granted only to non-members with the general or special sanction of the Registrar. However, Section 29 of the Cooperative Societies Act strictly prohibits granting of loan by a registered society to any person other than a member.

(v) **Shares Transfer** The auditor should check that no member of the Society having unlimited liabilities has transferred the shares without holding those shares for a minimum period of one year and has transferred the shares to any Society or member of the Society, as mentioned in Section 14 of the Cooperative Societies Act.

(vi) **Loan from Non-members** The auditor should also check that if the registered Society has taken loan from any non-member that is as per the prescribed rules and regulations, law of the Society as mentioned in Section 30 of the Act.

(vii) **Taxation** The auditor should check that if any exemption is available to a registered Society for tax, stamp duty, registration fees as per Section 28 of the Act, the same has been availed of by making application to the Central Government.

(viii) **Maintenance of Reserve** The auditor should ensure that a minimum of 25% of the net profit have been transferred to reserve and that the balance profit have been utilised properly.

**(ix) Valuation of Assets and Liabilities** The auditor should ensure that the assets and liabilities of the Society have been properly valued.

**(x) Investment** The auditor should check that investment has been made by the Society only in Government Savings; other registered society, and specified securities as per Section of Indian Trust Act, 1882 or in any other mode as per rules of the Society.

**(xi) Maintenance of Books and Accounts** The auditor should ensure that books of accounts have been maintained by the Society as per rules and regulations of the Society.

**(xii) Preparation of Financial Statements** The auditor should also ensure that financial statements of the Society have been prepared as per the prescribed rules and regulations.

**(xiii) Disbursement of Loans** Auditor should check whether there is any irregularity in disbursing loan to the members if any and realisation of loan from the members.

## 9.11 AUDIT OF HOSPITAL AND NURSING HOME

Hospital and nursing home are basically for providing various services to the public. The systems of keeping accounts of both are almost same. The following points need to be verified by the auditor at the time of verification of accounts of the hospital and nursing home:

**(i) Constitution** The auditor should verify legal status like Trust Deed, Title Deeds, etc. as per Acts and Regulations of nursing home and hospital.

**(ii) Internal Check** The auditor should investigate the internal check with respect to issues and receipts of stores, lines, apparatus, clothing and other equipment. He should confirm that purchase is made in accordance with purchase policies of the organisation.

**(iii) Checking of Different Registers and Documents** The auditor should check stock register, asset registers and other documents of the organisation. He should ensure that these documents and registers maintained and recorded properly and authenticated by the appropriate authority.

**(iv) Verification of Income Related Transactions** The auditor should check the following:

(a) Donations or grants received from time to time from the Government, local authorities, municipalities and others. Also see the accounting treatment of such receipts for the specific purposes.
(b) Billing and collection of money from the outdoor patients, patients in general and private wards.
(c) Examining income from other sources, like rent, interest and dividend from investment, etc.
(d) Vouch all the documents relating to the income of the hospital with accounts of the hospital.
(e) Checking the amount of outstanding and accrued income with the accounting entry.

(f) Get satisfactory explanations of the unbilled and concessional billing cases, if applicable.

**(v) Verification of Expenditure Related Transactions** The auditor should check the following:

(a) Proper entry of capital and revenue expenditures in the books of accounts.
(b) Depreciation on different fixed assets as per Companies Act and Income Tax Act.
(c) Purchase of medicines, stationeries, equipment, etc. and their entry in the books of accounts.
(d) Expenses relating to salaries of staff, wages, laundry, etc.
(e) Compare the actual expenses occurred with the budgeted amount and their proper utilisation.

**(vi) Assets** The auditor should see the entry of all the assets and their proper entry in the Balance Sheet.

**(vii) Liabilities** The auditor also must see the entry of all liabilities and their entry in the balance sheet.

**(viii) Stock Verification** Stock verification is necessary for reflecting actual position of the stock, like medicine, stationeries. So, the auditor should check stock as and when required.

**(ix) Compliance with Accounting Standards** The auditor should verify the form and way of presenting financial information comply with the accounting standards and applicable statutory requirements.

**(x) Management Representation and Certificate** The auditor will examine proper management representation and certificates with respect to various aspects covered during the audit course.

## 9.12 AUDIT OF A CLUB

A Club is a non-profit organisation which is meant for the development of local areas. The auditor must verify the following points at the time of auditing:

**(i) Formation and Constitution** The auditor should investigate the formation of club and scrutinise the Rules and Regulations of Club and the power and rights of the Governing Body and different members.

**(ii) Members Fees** The auditor should check amount of current subscriptions applicable to the various classes of membership including any provision for the payment of entrance fees and life subscriptions.

**(iii) Examination of Minute's Book** The auditor should check the minutes book of the Governing Body and ensure whether the powers have been appropriately exercised and the decision relating to finance.

**(iv) Verification of Income Related Transactions** The auditor should check the following:

(a) Entrance fees from the members and their respective entries in the cash book.

(b) Verify entries in cash book along with bank passbook.

(c) Scrutinise of subscription received from members with the counterfoils of receipts books.

(d) Interest or dividend received from investment and their records in the books of accounts.

(e) Examine the entry of donations received from different institutions or persons.

(f) Verify the treatment of admission fee and life membership fees.

(g) Rent received or receivable, if any.

(h) Examine the accrued subscription of the previous year/s.

**(v) Verification of Expenditure Related Transactions**

(a) The auditor should vouch the expenses of refreshment provided to members/ guests in the meeting.

(b) The auditor should verify expenses on purchase of sports goods, stationeries, etc.

(c) The auditor should verify all investments and ascertain their present values in the market.

(d) The auditor should vouch the value of depreciation on different fixed assets.

(e) The auditor should check the control of expenses over incomes in respect of tournaments organised by the club.

**(vi) Investment** The auditor should check shares, bonds and other financial assets with respect to investments. He should ensure the current value for disclosure in final accounts.

**(vii) Activities** The auditor should examine various activities like games, sports, social functions, etc. of a club. He should ensure that expenditure incurred in this connections approved by the competent authority.

**(viii) Maintenance of Accounts** The auditor should ensure that all the accounts of club are in conformity with the rules and regulations of the club.

**(ix) Verification of Assets and Liabilities** The auditor should physically verify the assets and examine the liabilities of a club on the closing date of accounts.

## 9.13 AUDIT OF HOTEL AND RESTAURANT

The main motive of hotel and restaurant is to earn profit by providing services to the customers. The auditor is to be very careful during the time of vouching all expenses and incomes of the hotel.

**(i) Verification of License** The auditor should verify the licence issued to the hotel and the range of facilities can be provided by the hotel and restaurant.

**(ii) Facilities and Services** Whether hotel or restaurant provides any other facilities like room for conference, swimming pool, bar, casino, health centre, etc. in addition to the accommodation should be examined by the auditor at the time of auditing.

**(iii) Internal Control** The auditor should verify the room rent receipts, occupancy reports on daily basis. He should see whether standard room rates have been charged in different guest bills. If there are variations, get the satisfactory clarifications and sanction of the same.

**(iv) Billing and Sales** The auditor should see the internal control system of all sales points in a hotel both cash and credit sales.

**(v) Stocks** The auditor should examine the documentation procedure in respect of stock of different items and also verify the basis of valuation adopted for stocks.

**(vi) Verification of Income Related Transactions** The auditor should check the following:

(a) Cash received from casual and temporary visitors.
(b) Cash realised from the boarders and also the unrealised amount to be adjusted at the time of closing of accounts.
(c) Rent from shops situated in the premises of the hotel.
(d) Cancellation charges for booking accommodation, if any.
(e) Receipts from letting out auditorium, conference room of the hotel.
(f) Receipts from providing foods to the visitors

**(vii) Verification of Expenditure Related Transactions** The auditor should check the following:

(a) Purchase of food materials, drinks and other materials.
(b) Stationary expenses.
(c) Payment of wages and salaries to the staff of the hotel.
(d) Payment made for purchasing of fixed assets.
(e) Decoration expenses on special days, if any.
(f) Telephone and laundry charges.

**(viii) Verify Total Volume of Sales in Bar and Restaurant** The auditor should examine whether a separate ledger is maintained for bar and restaurant for recording of transactions.

**(ix) Casual Labour** Generally, the hotels and restaurants employ casual labour to a large extent. So, the auditor should examine the wage payment registers and attendance to check manipulation.

**(x) Fixed Assets** The auditor should obtain a schedule of fixed assets and verify whether adequate depreciation has been provided at the prescribed rates. He should conduct physical verification of fixed assets and get management certificates for periodic inspections.

**(xi) Statutory Compliance** The auditor should check whether rules, regulations of various authorities have been complied with by the hotel or restaurant. He should also check whether all the foreign exchange transactions have been properly recorded and reported.

**(xii) Liabilities** He should verify share capital, reserves and surplus, secured and unsecured loans.

**(xiii) Management Representation and Certificates** The auditor should obtain the appropriate management representation and certification in respect of the various aspects of the audit.

## 9.14 AUDIT OF CINEMA HALL

Cinema hall is meant for entertaining the people on a regular way. Since most of the transactions are made in cash, so the auditor should be very careful at the time of vouching the documents.

**(i) Internal Control** The auditor should verify that adequate and proper internal control system and procedures have been designed and fulfilled with respect to tickets of different denominations sold to the spectators in cash as well through online payment systems.

**(ii) Selling of Tickets** The auditor must verify the systems of selling of tickets. Selling of advance tickets must also be taken into consideration at the time of vouching.

**(iii) Cash Collection** The auditor should examine the statement of tickets sold with the collection of cash at the end of the show with reference to the counterfoils collected at the entrance to the hall.

**(iv) Free Pass** He should verify that appropriate authority prevails for the free passes.

**(v) Verification of Income Related Transactions** The auditor should check the following:

(a) Sale proceeds from tickets of different denominations
(b) Sale proceeds from advance booking
(c) Receipts from advertisements and publicity
(d) Receipts from letting out hall on hire
(e) Receipts from amusement and entertainment tax
(f) Receipts from service tax
(g) Receipts on account of sale of books, drinks and refreshments

**(vi) Verification of Expenditure Related Transactions** The auditor should see the following:

(a) Hiring charges of films.
(b) Payment made for electricity charges
(c) Stationeries and required dress materials
(d) Remunerations paid to artists and staff of the cinema hall
(e) Expenses incurred in connection with the advertisements
(f) Purchase of snacks, drinks and other refreshments
(g) Amusement, entertainment tax and service taxes paid to the proper authorities
(h) Payments for repair and maintenance, etc.

**(vii) Cash Verification** The auditor should verify physically cash in hand including petty cash with the cash book.

**(viii) Fixed Assets and Depreciation** He should verify that fixed assets are recorded properly in the books of accounts and depreciation charged on different fixed assets of the cinema hall as per rules.

**(ix) Liabilities** Auditor should verify liabilities of the cinema hall at the end of the year. He should check whether adequate provision is made with respect to irrecoverable advances.

**(x) Restaurant** If a cinema hall runs any restaurant, he should value and verify closing stock of food, drinks and other refreshments.

## 9.15 AUDIT OF PUBLIC LIBRARY

The main objective of the public library is to provide access to the general people of the society to enrich their knowledge. The auditor must go through the Public Library Act and its rules and regulations before taking up the work of audit of accounts. The auditor needs to be very careful at the time of vouching the following points:

**(i) Constitution** The auditor should know the status of the library as to whether it is a registered society or a trust.

**(ii) Minute Book** The auditor should check out the minute books of the meetings of managing committee which can affect the finance and accounts of the library.

**(iii) Books and Periodicals Registers** Assets of the public library mainly constitute books and periodicals. The auditor should check that registers for books and periodicals are maintained properly. Books withdrawal register and deposit register are also required to be examined by the auditor.

**(iv) Verification of Transactions Related to Receipts** The auditor should check the following:

(a) Grants received from the Government or local authority, if any, should be vouched with proper documents.
(b) Subscription or membership fees received from the library users should be verified with the register and counter foils.
(c) The auditor should go through the register to check for security deposits against issue of library materials.
(d) Donation received, if any, should be vouched with the proper documents and matched with its entry in the account.
(e) Late fine received, if any, for the late return of books or periodicals should be checked.
(f) Income from other sources, like sale of old newspapers and other waste materials, dividend from investments, etc. be checked properly.

**(v) Verification of Transactions Related to Payments** The auditor should see the following:

(a) Payments made for purchase of books, periodicals, newspapers, etc. should be vouched with proper documents.

(b) Salaries of staff, electric charges and other expenses should be checked properly.

(c) Return of security deposit to the members should be taken into consideration during auditing.

(d) Proper utilisation of grant for the specific purpose should be verified by the auditor.

**(vi) Subscriptions** Accrued subscriptions from members should be accounted for and be verified by the auditor.

**(vii) Assets and Liabilities** Proper treatments of assets and liabilities in the balance sheet should be checked by the auditor.

**(viii) Depreciation** Depreciation charges on different fixed assets as per rules to be vouched properly by the auditor.

## 9.16 GOVERNMENT AUDIT

Government needs to undertake various activities for economic progress of the country. These activities involve huge monetary transactions. Government audit is undertaken to ensure optimum utilisation resources, i.e. the government fund towards the economic development of the country. At the Central level, the audit of accounts of public enterprises is carried out by the Comptroller and Auditor General (CAG) of India appointed by the President as per Article 148 of the Indian Constitution. The CAG of India, after completion of audit work, place the audit report on the table of Parliament. On the other hand, at State level, the audit of accounts of State Government enterprises is carried out by the Auditor General appointed by the State. The Auditor General places the audit report in the State Legislature through the Governor of the State. So, the systematic and independent examination of books of accounts of government organisations or public enterprises is known as government audit.

### 9.16.1 Basic Principles of Government Audit

The basic principles of government audit may be discussed from two aspects:

**A. In Respect of Expenditure**

**(i) Conformity to Rules and Regulations** The auditor should ensure that expenditures incurred for undertaking different activities are in accordance with the rules, regulations and legal provisions of the competent authority.

**(ii) Sanctioned by Competent Authority** The auditor should ensure that expenditures incurred have been sanctioned by the appropriate competent authority.

- **(iii) Maintaining Propriety** The auditor should ensure that expenditures that have been incurred are justified and that there is no unnecessary wastage of government funds, i.e., public fund.
- **(iv) Expenditure within Provisions** The auditor should confirm that if expenditures have been incurred out of provisions, they are within the prescribed limits.
- **(v) Audit of performance of Projects** The auditor should see that the projects involving huge amount of public money have been carried out efficiently, effectively and transparently.

**B. In Respect of Revenue**

- **(i) Realisation of Amount** The auditor should check whether the amounts to be received or revenues to be earned have been assessed, realised and the same have been credited to the government account.
- **(ii) Effective Check on Revenue Realisation** The auditor should ensure that there are effective rules and regulations relating to realisation and collection of government revenues.
- **(iii) Effective Check on Irregular Events** The auditor should ensure that there is an effective check system to detect and prevent irregularities, loss of revenue due to fraud, misappropriation on account of tax collection.
- **(iv) Proper Accounting for Donations, Subscriptions** The auditor should ensure that the donations, subscriptions received have been properly accounted for.

### 9.16.2 Features of Government Audit

The features of government audit are:

- (i) It ensures effective utilisation of government funds.
- (ii) It ensures proper accountability of public revenue and the expenditure is not more than the occasion demands.
- (iii) It checks the expenditure has been properly sanctioned according to the rules and regulations.
- (iv) It ensures payment has been properly and correctly classified.
- (v) Money due to others is regularly recovered and checked.
- (vi) The audit report is submitted to Government for discussion and necessary action.
- (vii) No such internal audit system exists in case of government audit.
- (viii) Audit work is carried out by the Audit and Accounts Department, Government of India.

### 9.16.3 Government Expenditure Audit

Audit of expenditure of government organisations or departments is conducted by the Comptroller and Auditor General (CAG) of India. The basic standards for expenditure audit are as follows:

**(i) Audit Against Rules and Orders** The auditor should check expenditures incurred comply with the relevant provisions of the law and according to the financial rules and regulations set by the competent authority.

**(ii) Audit of Sanctions** The auditor will examine that there are either special or general sanctions allowed by the competent authority authorising the expenditure.

**(iii) Audit Against Provisions and Funds** The auditor should see that there are provisions for funds out of which expenditure is incurred and authorised by the competent authority.

**(iv) Propriety Audit** The auditor should check that the expenditures have been incurred with due considerations to the board and general principles of the financial propriety.

**(v) Performance Audit** The auditor should check whether various programmes, schemes and projects, involving huge financial expenditures, are being implemented economically and efficiently.

## 9.17 AUDIT OF LOCAL BODY OR LOCAL SELF GOVERNMENT

A Local Body or Local Self Government (LSG) means an independent body or authority management of the local affairs by the people of the locality. It is based on the principle that the local problems and needs can be looked after better by the people of the locality than the Central or State Governments. Generally, local bodies are of two types—urban and rural local bodies. Urban local body includes Municipal Corporations, Municipal Councils, Notified Area Committees, Town Area Committees, Cantonment Boards and Townships. Rural local bodies are Zilla Parisad, Panchayat Samities and Gram Panchayat.

In order to perform its functions effectively, it is necessary that every local government body is provided with adequate finances. The services provided to the local inhabitants are largely financed out of finances raised locally. The local inhabitants are required to pay taxes imposed upon by the concerned local authority.

### 9.17.1 Objectives of Local Body Audit

The important objectives of Local Body audit are:

**(i) Fairness** To report fairness of the content and presentation of financial statements.

**(ii) Strength and Weakness** To report upon the strengths and weaknesses of systems of financial control.

**(iii) Legal Requirements** To report on the adherence to legal or land administrative requirements.

**(iv) Valuation** To report upon whether value is being fully received on money spent.

**(v) Prevention of Error** To detect error and prevent fraud and misuse of resources.

### 9.17.2 Audit Procedures of Local Body

Audit programme of a local body is discussed below:

**(i) Appointment of Auditor** The Local Fund Wing of the State Government is generally responsible for the audit of local bodies. Sometimes bigger municipal corporations, e.g. Kolkata, Delhi and Mumbai, etc. have power to appoint their own auditors for regular external audit.

**(ii) Scope** The auditor should check that the different programmes, plans, schemes and projects of State and Central Governments and other organisations where large financial expenditure has been incurred are running economically, effectively and getting the expected results.

**(iii) Accounting System** Conventional accounting system, i.e., cash based accounting system is being used by any local body. Usually, double entry accounting system are not being used by the local bodies. Auditor should check the accounting system of local bodies. If the local bodies are maintaining accounting records manually, then the auditor should be careful to examine their system of recording of transactions.

**(iv) Income** The main sources of income of local bodies are different types of taxes. Besides, local bodies receive grants from the State and Central Governments. The auditor should examine the methodology of determination and collection mechanism. He should ensure whether arrear taxes are deposited and recorded properly. Tax receipt books and online tax receipt mechanism should be verified by the auditor.

**(v) Expenditure** Expenditures incurred by the local bodies are classified into: (a) general administration, (b) revenue collection, (c) public health, (d) roads construction, (e) sanitation, (f) lighting, (g) primary education, (h) public safety, (i) water supply, and (j) roads and bridges maintenance. Besides, expenditures on capital heads, sanction from competent authority is required. The auditor should check all these expenditures as per the guidelines and sanctions of the appropriate authority.

**(vi) Budget** Local bodies prepare annual budget which reflects income and expenditure of different sources and heads. Auditor should check whether expenditure incurred as per the budgetary amount provided under various budget heads.

**(vii) Compliance** The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.

**(viii) Authenticity** The auditor should ensure that all types of sanctions either special or general approved by the competent authority.

**(ix) Authorisation** Authorisation refers to a person who is legally empowered to authorise an expenditure out of the earmarked budget. The auditor should check that the expenditure has been authorised by the competent authority.

**(x) Asset Register** The auditor should check different types of asset registers of local bodies to ensure whether they are maintained properly and authenticated by the competent authority.

## 9.18 AUDIT OF NON-PROFIT SEEKING ORGANISATIONS (NGOs)

A Non-Profit Seeking Organisation (NGO) can be constituted as a society under Societies Registration Act, 1860, as a Trust under Indian Trust Act, 1982, as a company under Section 8 of the Companies Act, 2013. Examples of NGOs are Ramakrishna Mission, Bharat Sevashram Sangha, UNICEF, Pratichi Trust, etc.

Audit of an NGO is discussed below:

**(i) Mission and Vision** The auditor should acquire knowledge about the mission and vision of the NGO and the area and extent of his work.

**(ii) Constitution** The auditor should know the statute under which the NGO has been formed. He should have updated knowledge about different legal provisions relating to the NGOs. He should acquire knowledge about the different documents like Memorandum of Association, Articles of Association, Project guidelines, Administrative guidelines and other relevant documents.

**(iii) Accounting System and Internal Control** The auditor check the accounting system used by the NGO and the internal control system existing in the organisation.

**(iv) Minute Book** The auditor should examine details of the minute book to collect the decisions regarding the various financial aspects taken at important meetings.

**(v) Donations and Grants** The auditor should see the following:

(a) Ensure that the funds received on account of donations, grants, and foreign contributions have been properly accounted for.

(b) He should ensure that reconciliation of the bank statement with regard to cash and cheque deposits of donations has been made referring to the date, amount and also receipt book.

(c) The auditor should ensure that if any assets have received as donation, that has been properly accounted for and it should be verified with the letter for grant or donor's agreement.

(d) Any amount of donations received must be verified with the letters from donors.

(e) In case of project sponsored by a donor, the auditor should verify the amount of expenditure made with the supporting documents and see that the balance left has been properly ascertained.

**(vi) Membership Fees/Subscriptions** Membership fees received from members should be verified by the auditor with the members register and counterfoil of receipts. The auditor should check that there is distinction between entrance fees, annual fees and life membership fees.

**(vii) Interest and Dividend** The auditor should verify the interest and dividends received with the investment register. He should physically verify the investment certificates.

**(viii) Contribution in Kind** If any contribution is received in kind, that should be verified by the auditor with the letter of the donor.

**(ix) Other Receipts** If any amount is received from any programme, that should be verified with the bank pass book.

**(x) Expenses** The auditor should

(a) Ensure that an expense on any project or programme is justified and has been sanctioned by competent authority.
(b) Check all the office and administrative expenses with relevant vouchers to confirm the genuineness of the transactions.

**(xi) Purchase and Disposal of Fixed Assets** The auditor should verify the purchase and disposal of fixed assets with supporting vouchers.

**(xii) Depreciation** The auditor should also ensure that the depreciation charged on fixed assets is in accordance with the provisions.

**(xiii) Investment** The auditor should verify the investment register with the investment certificates. Accrued interest on investment, if any, should be properly accounted for. The auditor should verify the purchase/disposal of investments with supporting vouchers.

**(xiv) Cash and Stock Verification** The physical cash in hand must be tallied with the account balance. Stock in hand should be verified by the auditor.

**(xv) Taxation** The auditor should see that if any tax benefits are available that have been properly accounted for.

**(xvi) Reserves** Any amount of transfer made to reserves from any project or programme must be checked by the auditor with the necessary supporting documents and the board resolution.

**(xvii) Special Funds** Special funds set aside for some special projects must be verified by the auditor with the letter of the donor, board resolution, agreement with the donor, rules and regulations of the organisation.

**(xviii) Loan** Loan taken by the NGO should be vouched by the auditor with the loan agreement, confirmation certificate from the lender, and borrowing capacity of the NGO.

**(xix) Establishment Expenses** The auditor should verify the provident fund, life insurance premium, ESI and their administrative charges are deducted, contributed and deposited within the prescribed time. He should check the office and other administrative expenses also.

**(xx) Corpus Fund** The auditor should check with reference to letter from donors and tally the interest income with the investment register and physical investment in hand.

## 9.19 COMPTROLLER AND AUDITOR GENERAL OF INDIA

The Comptroller and Auditor General (CAG) of India is an authority, established under Article 148 (Chapter V of Part V) of Indian Constitution. The CAG of India promotes accountability, transparency and good governance through high quality auditing and accounting. CAG audits all receipts and expenditure of the Government of India and the State Governments, including those of bodies and authorities substantially financed by the Government.

The Comptroller and Auditor General of India is the head of the Indian Audit and Accounts Department (IA&AD) and derives his constitutional standing as the auditor of the Union and State Governments from Articles 149 to 151 of the Constitution. The duties, powers and conditions of service of the Comptroller and Auditor General are laid down in the CAG's (Duties, Powers and Conditions of Service) Act, 1971.

In the case of a Government company, the CAG shall appoint the auditor under sub-section (5) or sub-section (7) of Section 139 and direct such auditor the manner in which the accounts of the Government company are required to be audited. The auditor shall submit a copy of the audit report to the CAG which, among other things, include the directions, if any, issued by the CAG, the action taken thereon and its impact on the accounts and financial statement of the company.

**(i) Appointment** The Comptroller and Auditor General of India is appointed by the President of India following a recommendation by the Union Cabinet. On appointment, he/she has to make an oath or affirmation before the President of India.

**(ii) Independence** The Constitution of India guarantees independence of the Comptroller and Auditor General of India.

**(iii) Removal** The CAG can be removed only on an address from both the Houses of Parliament on the ground of proved misbehaviour or incapacity. The CAG vacates the office on attaining the age of 65 years age even without completing the 6 years term.

**(iv) Duties and Powers** Article 149 of the Indian Constitution, the Comptroller and Auditor General shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States and of any other authority or body as may be prescribed by or under any law made by Parliament. The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 also prescribes duties and powers of CAG.

**(v) Remuneration and Service Conditions** The salary and other conditions of service of the CAG are determined by the Parliament of India through "The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971". His salary is same as that of a judge of the Supreme Court of India.

**(vi) Maintenance of Accounts** Article 150 of the Indian Constitution states that the accounts of the Union and of the States shall be kept in such form as the President may, on the advice of the Comptroller and Auditor General of India, prescribe.

**(vii) Submission of Accounts** Article 151 (1) of the Indian Constitution states that audit reports of the Comptroller and Auditor General of India relating to the accounts of the Union shall be submitted to the President, who shall cause them to be laid before each House of Parliament. Article 151 (2) of the Indian Constitution states that the audit reports of the Comptroller and Auditor General of India relating to the accounts of a State shall be submitted to the Governor of the State, who shall cause them to be laid before the Legislature of the State.

### 9.19.1 Constitutional Role/Duties of the Comptroller and Auditor General of India

The Constitution of India and the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 prescribe duties and powers of the Comptroller and Auditor General of India. So, the Comptroller and Auditor General of India plays an important constitutional role to maintain accounts and make audit of receipts and payments of State and Central Governments. These are discussed below:

#### A. To Compile Accounts of Union and States

The CAG to compile accounts of Union and States from the initial and subsidiary account rendered to the audit and accounts offices under his control. The CAG is responsible for the keeping of such accounts.

#### B. To Prepare and Submit Accounts to the President, Governors of States and Administrators of Union Territories having Legislative Assemblies

The CAG shall form the accounts compiled by him or by the Government or any other person responsible in that behalf, prepare each year's accounts. The accounts should reflect respective heads, the annual receipts and disbursements for the purpose of the Union, of each State and of each Union territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union territory having a Legislative Assembly.

#### C. To Give Information and Render Assistance to the Union and States

The Comptroller and Auditor General of India is responsible to provide information, render assistance in the preparation of their annual financial statements to the Union Government, to the State Governments or to the Governments of Union Territories having Legislative Assemblies.

### D. General Provisions Relating to Audit

The duties of the Comptroller and Auditor General in relation to audit are:

(a) to audit all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly;

(b) to ascertain whether the amounts shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(c) to audit all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(d) to audit all Trading, Manufacturing, Profit and Loss Accounts and Balance Sheets and other Subsidiary Accounts kept in any department of the Union or of a State; and in each case to report on the expenditure, transactions or accounts so audited by him.

### E. Audit of Receipts and Expenditure of Bodies or Authorities Substantially Financed from Union or State Revenues

Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the CAG audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

### F. Functions of Comptroller and Auditor General in the Case of Grants or Loans given to other Authorities or Bodies

Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the CAG shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfilment of the conditions.

### G. Audit of Receipts of Union or of States

The CAG will audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly. He is to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.

### H. Audit of Accounts of Stores and Stock

The CAG shall have authority to audit and report on the accounts of stores and stock kept in any office or department of the Union or of a State.

**I. Audit of Government Companies and Corporations**

The duties and powers of the CAG in relation to the audit of the accounts of Government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013.

**J. Audit of Accounts of Certain Authorities or Bodies**

The audit of the accounts of certain authorities or bodies has not been entrusted to the CAG by or under any law made by Parliament. He shall, if requested by the President, or the Governor of a State or the Administrator of a Union Territory having a Legislative Assembly, as the case may be, undertake the audit of the accounts of such body or authority on such terms and conditions as may be agreed upon between him and the concerned Government.

### 9.19.2 Powers of the Comptroller and Auditor General of India in Connection with Audit of Accounts

The CAG shall in connection with the performance of his duties under the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 have authority:

(i) to inspect any office of accounts under the control of the Union or of a State, including treasuries, and such offices responsible for the keeping of initial or subsidiary accounts, as submit accounts;

(ii) to require that any accounts, books, papers and other documents which deal with or form the basis of or an otherwise relevant to the transactions to which his duties in respect of audit extend, shall be sent to such place as he may appoint for his inspection;

(iii) to put such questions or make such observations as he may consider necessary, to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which it is his duty to prepare.

The person in charge of any office or department, the accounts of which have to be inspected and audited by the CAG, shall afford all facilities for such inspection and comply with the requests for information in as complete a form as possible and with all reasonable expedition.

## SUMMARY

- **Audit of Banks** The Guidance Note on Audit of Banks issued by the Institute of Chartered Accountants of India in 1994 and subsequently revised by the Institute time to time (last revised in 2016). The Legislations relevant to Audit of Banks are:
  - (i) Reserve Bank of India Act, 1934
  - (ii) Banking Regulation Act, 1949
  - (iii) State Bank of India Act, 1955
  - (iv) Companies Act, 2013
  - (v) State Bank of India (Subsidiary Banks) Act, 1959

(vi) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
(vii) Regional Rural Banks Act, 1976
(viii) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
(ix) Information Technology Act, 2000
(x) Prevention of Money Laundering Act, 2002
(xi) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
(xii) Credit Information Companies (Regulation) Act, 2005
(xiii) Payment and Settlement Systems Act, 2007

- **Internal Control of Banks** The general scheme of internal controls in a bank are: Division of work and rotation of duties and Accounting procedures.
- **Non-Performing Asset (NPA)** An advance which does not disclose any problems and does not carry more than the normal risk is associated to the banking business is called standard assets. A non-performing asset is also an advance other than a standard asset. NPAs may be classified into Sub-standard, Doubtful and Loss assets.
- **Long Form Audit Report** Long Form Audit Report (LFAR) is a separate report to be submitted to the management, in the format prescribed issued by the RBI in addition to statutory audit report. The LFAR highlights certain important aspects of the working of the banks such as internal control system, accounting policies, profitability and financial position.
- **Audit Procedure of Insurance Companies** The following aspects are to be considered in case of audit of insurance companies - (i) Review of internal control; (ii) Receipts of premium; (iii) Verification of cancelled policies; (iv) Accounting treatment of premium; (v) Accounting treatment of claims; (vi) Payment of commissions; (vii) Income from investment; (viii) Remuneration of employees; (ix) Management expenses; (x) Interest and bank charges.
- **Audit of Educational Institutions** The auditor should check (i) Constitution; (ii) Minutes Book; (iii) Budget; (iv) Verification of transactions related to receipts; (v) Verification of transactions related to payments; (vi) Employees benefit funds; (vii) Maintenance of different registers; (viii) Depreciation; (ix) Taxation; (x) Financial information; (xi) Certificates.
- **Government Audit** Government audit is undertaken to ensure optimum utilisation resources i.e. the government fund towards the economic development of the country. (i) At central level audit of accounts of public enterprises is carried out by Comptroller and Auditor General of India (CAG) appointed by the President as per Article 148 of the Indian Constitution. Comptroller and Auditor General of India, after completion of audit work, place the audit report to the President. (ii) At state level, audit of accounts of state government enterprises is carried out by Auditor General appointed by the state. The Auditor General places the audit report in State legislature through Governor of the state.

- **Audit Procedures of a Local Body** The auditor check and verify: (i) Appointment of auditor; (ii) Accounting system; (iii) Checking of income; (iv) Checking of expenditure; (v) Examination of budget; (vi) Verify compliance; (vii) Ensure authenticity; (viii) Checking of asset register.
- **Audit of Non-Profit Seeking Organisations (NGOs)** In case of auditing of NGOs, the auditor should check and verify – (i) Mission and vision; (ii) Constitution; (iii) Accounting system and internal control; (iv) Minute book; (v) Donations and grants; (vi) Membership fees/subscriptions; (vii) Interest and dividend; (viii) Contribution in kind; (ix) Expenses; (x) Purchase and disposal of fixed assets; (xi) Investment; (xii) Cash and stock verification; (xii) Reserves; (xiv) Special funds; (xv) Loan; (xvi) Corpus fund; (xvii) Establishment expenses.
- **Comptroller and Auditor General of India** The Comptroller and Auditor General of India (CAG) is the head of the Indian Audit and Accounts Department (IA&AD) and derives his constitutional standing as the auditor of the Union and State Governments from Articles 149 to 151 of the Constitution. Role and duties of CAG are: (i) To compile accounts of Union and States; (ii) To prepare and submit accounts to the President, Governors of States and Administrators of Union Territories having Legislative Assemblies; (iii) To give information and render assistance to the Union and States; (iv) To audit all expenditure from the Consolidated Fund of India; (iv) To audit all transactions of the Union and of the States relating to Contingency Funds and Public Accounts; (v) Audit of receipts of Union or of States; (vi) Audit of accounts of stores and stock; (vii) Audit of Government companies and corporations; (viii) Audit of accounts of certain authorities or bodies.

## EXERCISE

### A. Medium Answer Type Questions (4–6 marks)

1. Mention five relevant legislations relating to audit of banks.
2. State important provisions of relating to bank audit.
3. Discuss Non-Performing Assets of a Bank. [*C.U. B.Com(H), 2007*]
4. Explain about Long Form Audit Report of a bank. [*C.U. B.Com(H), 2006, 2008, 2010, 2012*]
5. Write short notes on Non-Performing Assets. [*C.U. B.Com(H), 2011, 2013*]
6. Explain with examples what is meant by Non-Performing Assets. [*C.U. B.Com(H), 2009*]
7. Explain the special features of audit of an insurance company. [*C.U. B.Com(H), 2010*]
8. Write short notes on Evaluation of Internal Control System of an insurance company. [*C.U. B.Com(H), 2008*]

9. Mention the important points relevant for audit of insurance companies. [*C.U. B.Com(H), 2012*]
10. State the objectives of government audit.
11. Describe in brief the role of Comptroller and Auditor General (CAG) of India. [*C.U. B.Com(H), 2013*]
12. Discuss the powers of Comptroller and Auditor General of India in connection with audit of accounts.

**B. Essay Type Questions** **(8–10 marks)**

1. Discuss the relevant legislations while conducting audit of banks.
2. Explain approach to bank audit.
3. Discuss the procedure for bank audit.
4. Evaluate internal control of banks while auditing.
5. State the rules for identifying NPA as per Banking Regulation Act, 1949.
6. Discuss the legislation relevant to audit of insurance companies.
7. Review of internal control system of an insurance company.
8. Discuss audit report of insurance companies as per IRDA.
9. Discuss the audit procedure in respect of insurance premium of an insurance company. [*C.U. B.Com(H), 2014*]
10. Prepare an audit programme of a sports club. [*C.U. B.Com(H), 1991, 2000*]
11. Prepare an audit programme of a medical college. [*C.U. B.Com(H), 1991, 2001*]
12. Prepare an audit programme of a cooperative society. [*C.U. B.Com(H), 1993, 1998*]
13. How would you carry out the work of audit of a cinema hall as an auditor? [*C.U. B.Com(H), 1998*]
14. How would you carry out the work of audit of a hotel as an auditor? [*C.U. B.Com(H), 2000*]

    Or

    What are the special points to be taken into consideration during audit of a hotel? [*C.U. B.Com(H), 2002*]
15. Mention the special items to be emphasised while conducting audit of a college. [*C.U. B.Com(H), 2003*]
16. Draft an audit programme of a college audit. [*C.U. B.Com(H), 2003, 2008, 2011*]
17. Prepare an audit programme in respect of audit of a hospital. [*C.U. B.Com(H), 2004, 2013*]
18. Prepare an audit programme of a private college. [*C.U. B.Com(H), 2006*]
19. Write up an audit programme of a university. [*C.U. B.Com(H), 2009*]
20. Prepare an audit programme of a hospital. [*C.U. B.Com(G), 2014*]
21. Prepare an Audit programme of a government college. [*C.U. B.Com(G), 2015*]
22. Prepare an audit programme of a Non-Government Organisation.
23. Prepare an audit programme of a local body.
24. Discuss the constitutional role of the Comptroller and Auditor General of India.

# 10 CHAPTER AUDIT INVESTIGATION

## CHAPTER OUTLINE

**10.1** Introduction
**10.2** Characteristics/Features of Investigation
**10.3** Purpose of Investigation
**10.4** Distinction between Auditing and Investigation
**10.5** Types of Investigations
**10.6** Investigations in Certain Situations

## 10.1 INTRODUCTION

In the words of **Taylor and Perry**, investigation involves inquiry into facts behind the accounts, i.e., into the technical, financial and economic position of the business organisation. **Investigation is an in-depth examination of books and records for any special purpose**. Such examination may involve both financial and non-financial information.

Generally, an attempt made to find out the facts behind a particular situation, or to ascertain the truth is known as investigation. In the case of a business organisation, investigation refers to a planned, meticulous and critical examination of the books of accounts and transactions (both past and present) of an entity. The most common methods employed in the process of investigation are probing, examination, questioning, inquiry, inspection, etc.

## 10.2 CHARACTERISTICS/FEATURES OF INVESTIGATION

The main features of investigation are stated below:

**(i) Not Always Mandatory** Investigation is not always compulsory. It is often conducted on voluntary basis depending upon necessity. However, statutory investigation is required as per the provisions of Sections 210, 212, 213 and 216 of the Companies Act, 2013.

**(ii) Special Purpose** Investigation is an examination of books and records for any special purpose like to know financial position, earning capacity, prove fraud, invest capital, etc.

**(iii) Time Horizon** Investigation may be conducted for several years at a time, say three years. In fact, the time horizon depends upon the requirement. There is no specific periodicity requirement.

**(iv) Detailed Examination** Investigation is a thorough checking of the books of account for a particular year or a number of years.

**(v) Scope** The scope of the investigation is generally limited since it attempts to answer only those questions that are asked in the engagement letter.

**(vi) Submission of Report** Investigation report is addressed to the party on whose instruction investigation was conducted.

**(vii) Flexibility** The investigator is free to design his plan of action as per the requirements of the concerned case. His design of plan is on the basis of his personal wisdom and judgement.

**(viii) Accountability** The investigator is accountable only to the person who appoints him for conducting investigation.

## 10.3 PURPOSE OF INVESTIGATION

The actual aim of conducting an investigation by an auditor on behalf of his client is to supply him the required information in the form of a report about the matter specified. By and large, the purpose of an investigation is to collect, examine and appraise the facts in respect of desired field of activity for some special purpose as determined by the person on whose behalf the investigation is carried out. Nevertheless, the common objectives of an investigation are stated below:

**(i) Proposed Purchase of Business** Before purchasing a business, a client may appoint an investigator to examine the different aspects of the said business so that the investigator can give his views as to whether it will be prudent to go ahead with purchasing decision.

**(ii) Reasons for Low Profitability** An investigator may be appointed to find out the causes of low profitability of a business and the ways to improve the same.

**(iii) Cause of High Employee Turnover** When the employees are frequently leaving an organisation, an investigator may be appointed to examine the causes of such high employee turnover so that appropriate measures can be taken to settle the issue.

**(iv) Proposed Investment in Particular Securities** Before investing in particular securities, a client may appoint an investigator to examine the rightness of such investment.

**(v) Suspected Fraud** In case of any suspected fraud, an investigation may be conducted to identify the nature of fraud and the persons involved in fraudulent activities.

**(vi) Joining in Existing Partnership Business** Before entering into a new partnership firm, a client may appoint an investigator to examine the profitability and solvency position of the firm, the reasons for admitting new partners, etc. in order to make sure that the decision as to entering into a new partnership firm does not backfire.

**(vii) Lending Funds** The lending institutions like banks, non-banking financial companies, etc. appoint an investigator to judge the creditworthiness of the prospective borrower.

**(viii) Determining Sickness** In order to judge the nature and extent of sickness and the possibility of revival an investigation may be conducted.

**(ix) Settling Insurance Claim** An investigator may be appointed by a general insurance company to examine whether the claims submitted by the insured in relation to events like fire or other hazards are justified or not.

**(x) Unusual Decline in Profit** An investigator may be appointed to find out the causes of unusual decline in profit so that appropriate actions can be taken.

**(xi) For Business Combination** An investigator may be appointed for carrying out investigation work in relation to financial, technical, and administrative aspects of the concerned units.

**(xii) Provisions of the Companies Act** Statutory investigation is required as per the provisions of Sections 210, 212, 213 and 216 of the Companies Act, 2013.

## 10.4 DISTINCTION BETWEEN AUDITING AND INVESTIGATION

There exist substantial differences between audit and investigation. These differences are enumerated below.

| S.No. | Points of Difference | Auditing | Investigation |
|---|---|---|---|
| 1. | Legal binding | Audit of annual financial statements is compulsory under the Companies Act, 2013. | Investigation is not compulsory in most cases under Companies Act but voluntary depending upon necessity. |
| 2. | Time Horizon | Audit is conducted usually on annual basis. | Investigation may be conducted for several years at a time, say three years. In fact, the time horizon depends upon the requirement. There is no specific period. |
| 3. | Object | Audit is conducted to ascertain whether the financial statements show a true and fair view. | Investigation is conducted with a particular object in view, viz to know financial position, earning capacity, prove fraud, invest capital, etc. |

(Contd.)

| | | | |
|---|---|---|---|
| 4. | Report submission | Audit report is addressed to shareholders (or proprietors or partners). | Investigation report is addressed to the party on whose instruction investigation was conducted. |
| 5. | Person performing work | Audit is to be conducted by a chartered accountant. | Investigation may be undertaken even by a non-chartered accountant. |
| 6. | Parties for whom conducted | Audit is conducted on behalf of shareholders (or proprietor, or partners). | Investigation is usually conducted on behalf of outsiders like prospective buyers, investors, lenders, etc. |
| 7. | Checking Method | In case of audit test checks are applied. | Investigation is a thorough checking of the books of account for a particular or number of years. |
| 8. | Scope | The scope of auditing is general, which attempts to give an opinion on the financial statement of the company. | The scope of the investigation is limited as it attempts to answer only those questions that are asked in the engagement letter. |
| 9. | Nature of Evidence | Audit is usually concerned with prima-facie evidence. | Investigation is usually concerned with conclusive evidence. |

## 10.5 TYPES OF INVESTIGATIONS

Investigation is of two types: (a) Non-statutory Investigation, and (b) Statutory Investigation.

### 10.5.1 Non-statutory Investigation

Non-statutory investigation may be of the following types:

(i) Investigation on behalf of an individual or a firm for the purchase of a business.
(ii) Investigation in connection with the preparation of the report.
(iii) Investigation on behalf of a bank or a non-banking financial company (NBFC) or a lending institution for credit or lending purpose.
(iv) Investigation on behalf of an individual or an institution intending to make investment in an organisation.
(v) Investigation for the detection of suspected or actual fraud.
(vi) Investigation on behalf of an incoming partner who intends to join a partnership firm.
(vii) Investigation by tax authority to ascertain the correct amount of tax liability.
(viii) Investigation for the purpose of reviewing the profit forecast.

### 10.5.2 Statutory Investigation

Statutory investigation is required as per the provisions of Sections 210, 212, 213 and 216 of the Companies Act, 2013. Investigation under the Companies Act, 2013 can be broadly divided into two categories: (i) Investigation into the affairs of a company, and (ii) Investigation of ownership of a company.

### A. Investigation into the Affairs of a Company

It can be further divided into three parts:

*(i) Investigation into the affairs of a company by an inspector through an order of the Central Government (Section 210)*

The Central Government on forming opinion may order an investigation:

- on receipt of a report of the Registrar or Inspector under Section 208
- on intimation of special resolution passed by a company
- in public interest

The Central Government shall also order an investigation based on an order passed by a Court or Tribunal.

The Central Government may appoint one or more inspector to investigate into the affairs of the Company and report in the manner as directed by the Central Government.

*(ii) Investigation into the affairs of a company by Serious Fraud Investigation Office (Section 212)*

The Central Government is empowered to order investigations by SFIO:

- on receipt of a report of the Registrar/Inspector under Section 208
- on intimation of special resolution passed by a company
- in Public interest
- on request from any Department of the Central Government or State Government

Once an investigation is ordered by the Central Government for SFIO, no other investigating agency of the Central Government or any State Government shall proceed with the investigation in such case in respect of any offence under this Act. Further, in case where any such investigation has already been initiated, it shall not be proceeded further with and the concerned agency shall transfer the relevant documents and records in respect of such offences under this Act to SFIO.

*(iii) Investigation into the affairs of a company in other cases (Section 213)*

The Tribunal may order investigation into the affairs of a company:

- on applications by specified number of members
- on allegations of fraudulent activities of the company or unlawful purposes or other matters specified under Section 213(b)

### B. Investigation of Ownership of a Company

The Central Government is empowered to appoint inspectors to investigate and report on matters relating to a company and its membership to determine true persons:

- who are or have been financially interested in the success or failure, real or apparent.
- who are or have been able to control or to materially influence the policy of the company.

Such investigation may be ordered by the Central Government on orders by the Tribunal. The Central Government may define the scope of the investigation, define the period or limit investigation to matters with particular shares or debentures.

## 10.6 INVESTIGATIONS IN CERTAIN SITUATIONS

### 10.6.1 Investigations to Detect Fraud, Misappropriations and Defalcations

Fraud is an intentional false representation with some mischievous objectives for the purpose of obtaining an unjust or illegal advantage. Fraud may be of two types: (1) Misappropriation and (2) Manipulation or falsification of accounts. Misappropriation may again be of two types: (a) Misappropriation of cash and (b) Misappropriation of goods.

When an investigator is appointed to examine any suspected fraud, he has to undertake certain preliminary work such as:

(i) He has to make himself familiar with the nature of the organisation.
(ii) He has to discuss with the client about the reasons for suspecting fraud.
(iii) He has to ascertain whether fraud relates to misappropriation or falsification of accounts.
(iv) He has to examine the adequacy of the internal control system in the area where fraud is suspected.

The procedure of investigation varies depending on the types of fraud.

#### A. Investigation Procedure for Misappropriation of Cash

There is no one-size-fits-all procedure for detecting misappropriation of cash. It varies from circumstance to circumstance. However, the investigator may design his procedure of investigation in the following manner:

(i) Adequacy of the internal control system with respect to cash receipts and cash payments has to be verified.
(ii) Unusual items like unusual cash receipts or unusual old debtors' balance have to be examined carefully.
(iii) Vouchers in support of petty cash transactions have to be verified thoroughly. At the same time, checking has to made as to whether such vouchers have approval from competent authority.
(iv) Whether "teeming and lading" method has been applied or not has to be ascertained.
(v) The investigator has to examine whether there is any double payment or not.
(vi) Whether payment to creditors has been made by way of 'A/c Payee Cheque' or not has to be ascertained.
(vii) The investigator has to gather quotations from alternative sources with regard to some high value transactions to ascertain the propriety or justness of such transactions.
(viii) Whether discount has been allowed to the customers in accordance with the rules of the organisation or not has to be checked.

(ix) Entries of pass book and cash book have to be verified with the entries recorded in counterfoils of paying-in-slips.

(x) Whether debtors are making payment by way of 'A/c Payee Cheque' or not has to be ascertained.

**B. Investigation Procedure for Misappropriation of Goods**

There is a usual tendency to misappropriate such goods which are high in value, but small in size. It is not easy to detect such misappropriation. Nevertheless, the investigator may design his procedure of investigation in the following manner:

(i) Adequacy of the internal control system with respect to receipts and issue of materials to and from stores has to be verified.

(ii) Whether goods distributed as free samples have been properly accounted for or not has to be examined.

(iii) Adequacy of the stock taking system has to be judged.

(iv) In case the loss of stock is not normal, the investigator has to examine the reasons for the same.

(v) The procedure of purchase has to be verified thoroughly in order to make sure that goods have been purchased as per the requirement.

(vi) The investigator has to check whether the goods sold are delivered or not. For this, checking of Sales Book, Stock Book, Gate Pass, Challan of transporters, etc. are essential.

(vii) If the organisation has branches, the investigator has to examine goods sent to the branches and goods received by the branches.

**C. Investigation Procedure for Manipulation or Falsification of Accounts**

Falsification of accounts is usually done to overstate or understate profits of the organisation. The profit is understated to pay less tax. On the other hand, profit may be overstated to pay more dividend or to earn extra commission. Since manipulation of accounts is done in a planned way and the management of the organisation is directly or indirectly involved in such manipulation, it is not easy to detect falsification of accounts. However, the investigator may design his procedure of investigation in the following manner:

(i) The method of stock valuation should be carefully examined.

(ii) Whether allocation of expenditure has been properly made between capital and revenue has to be verified.

(iii) Transactions, especially purchases and sales transactions, that have taken place at the end of the year, have to be thoroughly examined.

(iv) The investigator has to check certain ratios (gross profit ratio, net profit ratio, etc.) of the current year and compare the same with the figures of the previous years. In case abnormality is noticed, the investigator has to verify the matter deeply.

(v) Whether the rates of depreciation are properly applied or not has to be examined.

## 10.6.2 Investigations with respect to Business Combinations

In order to justify whether a business combination between two or more organisations should be effected or not, an investigation may be carried out. Such investigation should have the following approach:

### A. Examining the Background of the Companies

It is necessary to look into the background of the promoters of the concerned organisations which intend to be combined. By examining the previous history of the promoters an idea about the possibility of clash of interest between them may be formed.

### B. Looking into Overall Situation

It is necessary on the part of the investigator to look into the matters like nature of business, production or manufacturing process, type and source of raw materials, existing market of the product or service, use of technology, employment condition, etc.

### C. Exploring the Possible Impact of Combination

The investigator has to study the possible impact of the proposed combination like:

(i) Whether it will result in cost reduction
(ii) Whether the effect of 'synergy' can be obtained
(iii) Whether growth in topline and bottomline can be achieved
(iv) Whether risk can be minimised
(v) Whether debt will be increased
(vi) Whether the enhanced market share of the proposed combination can lead to low competition

### D. Examining the Statement of Profit and Loss

It is an important task on the part of the investigator to go through the statements of profit and loss of the previous 5-10 years of the entities in detail. While examining such statements, the investigator should carefully look into the following:

(i) Whether proper allocation of expenditure between capital and revenue has been made
(ii) Whether accounting policies have been strictly adhered to
(iii) Whether adequate provision has been made for depreciation

### E. Determining "Purchase Consideration"

After careful consideration of factors like intrinsic value, market value of shares and other significant factors, the investigator has to determine the amount of purchase consideration to be paid.

#### F. Examining the Nature of Financing

The investigator has to carefully examine the nature of financing of the proposed combination, i.e., whether it will be all-cash settlement or settlement through exchange of shares or a combination of both. The impact of the proposed combination on the entity's earning per share (EPS), cost of capital, and liquidity has to be studied.

#### G. Assessing the Impact on Management and Employee

The impact of the proposed combination on the management and employees has to be assessed thoroughly. The assessment should include the following:

(i) Whether the combination will make the employees redundant
(ii) Whether the existing pay package will be adversely affected
(iii) Whether the nature of job of the proposed combination will be suitable to retain all the managerial personnel

#### H. Assessing the Financial Stability of the Business

The investigator should assess the financial stability of the entities by examining carefully items like contingent liability, working capital, debt-equity position, etc.

### 10.6.3 Investigation into the Sickness of an Organisation/Company

In order to examine the nature and extent of sickness of an organisation, the investigator should adopt the following procedure:

#### A. Examining the Causes of Sickness

An organisation may be born sick or it may become sick with the passage of time. The reasons for sickness are plenty. Some reasons for sickness from the beginning are inappropriate site selection, choosing improper technology, selection of wrong product, etc. On the other hand, some reasons for subsequent sickness are managerial inefficiency, changes in government policy, market constraints, etc. The investigator has to identify the causes of sickness and then he has to ascertain whether those causes are controllable or not.

#### B. Judging the Extent or Degree of Sickness

The investigator has to determine the extent of sickness with the help of certain ratios like (i) Earnings before depreciation, interest and tax (EBDIT) to sales, (ii) EBDIT to total assets, (iii) Operating cash flow (OCF) to sales, (iv) OCF to total assets, etc. The ratios of the organisation have to be compared with the industry average or standard. Further, the investigator has to examine the financial statements to ascertain (i) whether allocation of expenditure has been properly made between capital and revenue, (ii) whether assets are properly valued or not, (iii) whether all liabilities are properly accounted for, (iv) whether fictitious sales have taken place, etc.

### C. Exploring the Revival Possibility

If the investigator is satisfied that the organisation has the potential to cut down operating loss gradually or it has the possibility to generate positive net worth in the near future, he can recommend the revival of the organisation. Such recommendations are usually made when the identified reasons for sickness are mostly controllable in nature.

### D. Suggesting Revival Measures

The investigator should suggest short-term as well as long-term measures for reviving the sick organisation. Short-term measures include: (i) proper performance monitoring system, (ii) proper management of finance, (iii) measures for improving productivity, (iv) measures for enhancing capacity utilisation, (v) capital re-organisation scheme, etc. Long-term revival measures are: (i) use of modern and upgraded technology, (ii) designing product as per market demands, (iii) changing product-mix to match the taste of consumers, (iv) conducting surveys and market research. Short-term measures relate to improving profitability and liquidity position of the concern whereas long-term revival measures are associated with the future development of the organisation. These measures require funding from various sources. As such, the investigator has to ascertain the proper sources of funding.

## 10.6.4 Investigation on Behalf of New/Incoming Partner

In order to determine whether it will be prudent to enter into an existing partnership firm, the investigator has to look into the following aspects:

### A. Checking the Deed of Partnership

In order to make sure that the interest of his client (incoming partner) is duly protected, it is absolutely essential on the part of the investigator to examine in detail the deed of partnership, both the existing one and the proposed one.

### B. Examining the Profitability and Future Potential of the Firm

The profit-earning capacity of the business is to be examined with reference to items appearing in the financial statements like sales, expenses, gross profit, net profit, etc. In order to understand the trend of the business financial statements of 5–7 years have to be studied in detail. Such examination will enable the investigator to arrive at an opinion about the future potential and prospect of the firm. This apart, the investigator has to judge the consequences of future events like government policy, competition, demand for the product, etc.

### C. Assessing the Financial Position of the Firm

Detailed investigation of assets and liabilities of the firm for a period of at least 5–7 years will enable the investigator to form opinion about the liquidity and solvency position of the organisation.

### D. Examining the Reasons for Taking New Partner

The investigator has to ascertain why the firm is interested in taking a new partner. If the reasons for admitting new partner are favourable from the perspective of his client, he may give a 'go-ahead' subject to suitability of other factors.

### E. Examining the Rightness of Capital Contribution

The investigator has to examine whether the amount of capital to be brought in by his client is consistent with the capital of other existing partners of the firm. The purpose for which the capital of his client will be utilised by the firm has also to be verified. It may be utilised for enhancing the working capital of the firm or it may be used to pay back the capital of the retiring or deceased partner. In the latter case, there may be pressure on the working capital of the firm which may adversely affect the future prospect of the firm.

### F. Examining the Rightness of the Amount of Premium for Goodwill

The investigator has to examine the method of goodwill valuation of the firm. He has to verify whether amount of premium for goodwill to be brought in by his client is rational or not.

### G. Justifying the Share of Profit

The investigator has to ascertain whether the share of profit of his client is just or not.

### H. Enquiring into Administrative Matters

The investigator has to judge whether the duties and responsibilities of his client are consistent with the duties and responsibilities of other existing partners. Further, if partners are entitled to receive salary, the investigator has to examine whether such salary commensurate with the duties and skills.

### I. Examining the Relationship Between Existing Partners

Mutual trust and confidence is the pillar on which the partnership business stands. As such, it is of utmost importance that the investigator should verify the relationship between the existing partners.

## 10.6.5 Investigation for Settling General Insurance Claim

An investigator may be appointed by a general insurance company to examine whether the claims submitted by the insured in relation to events like fire or other hazards are justified or not. However, the investigator has to look into the following aspects:

### A. Finding Out the Cause

The investigator has to find out the causes of the event (fire, accident, natural calamity, etc.). For this purpose, opinion of forensic experts may be sought as well.

#### B. Reporting Time

The investigator has to check the time of submission of application for settling the claim. If the intimation is not given within the stipulated time period, the reason for delay has to be examined carefully.

#### C. Putting Emphasis on 'Causa Proxima'

Emphasis should be put on the principle of 'Causa Proxima' which means when a loss is caused by more than one causes, the proximate or the nearest or the closest cause should be taken into consideration to decide the liability of the insurer. Accordingly, to find out whether the insurer is liable for the loss or not, the proximate (closest) and not the remote (farest) must be looked into by the investigator.

#### D. Examining Loss Minimising Effort

According to the principle of loss minimisation, the insured must always try his level best to take all possible measures and necessary steps to minimise the loss of his insured property, in case of uncertain events like a fire outbreak or blast, etc. Hence, it is the duty of the investigator to examine whether the insured is negligent and behaving irresponsibly during such events.

#### E. Insurable Interest

The principle of insurable interest states that the person getting insured must have insurable interest in the object of insurance. In simple words, the insured person must suffer some financial loss by the damage of the insured object. As such, the investigator has to determine whether the insured has insurable interest in the object of insurance.

#### F. Utmost Good Faith

The principle of 'Uberrimae fidei' (a Latin phrase), or the principle of 'utmost good faith', is the primary principle of insurance. According to this principle, the insurance contract must be signed by both parties (i.e., insurer and insured) in an absolute good faith or belief. Accordingly, the investigator has to determine whether any material facts are omitted, hidden, falsified or presented in a wrong manner by the insured.

#### G. Verifying Preventive Measures

The investigator has to verify whether proper preventive measures have been taken or not by the concerned institution during and after the mishap.

### 10.6.6 Investigation Before Granting Loan to an Organisation

The lending institutions like banks, non-banking financial companies, etc. appoint investigator to judge the creditworthiness of the prospective borrower. In such cases, the investigator has to look into the following aspects:

### A. Examining Profit-earning Capacity

It is absolutely essential for the investigator to examine the profit-earning capacity of the concern before sanctioning loan. For this purpose, statements or accounts of profit or loss of the concerned organisation have to be checked properly.

### B. Ascertaining the Reasons for Loan Application

The investigator has to ascertain why the concerned organisation has applies for loan. If the reasons are justified, he may look into the other matters.

### C. Judging the Financial Position

In order to judge the liquidity, solvency, etc., the investigator has to carefully examine the assets and liabilities of the concern for at least 5–7 years.

### D. Examining the Loan Repayment Capacity

Whether the organisation has the capacity to repay the loan in time has to be verified. If the organisation has taken a loan from other institutions in earlier periods, the investigator may contact the officials of such institutions for the purpose of ascertaining the loan repayment capacity.

### E. Verifying the Adequacy of Mortgage

Whether the instruments to be kept as mortgage are adequate or not has to be verified carefully by the investigator.

### F. Verifying Contingent Liability

The investigator has to verify whether there is any contingent liability of the concerned organisation. If such liability exists, the nature and extent of those liabilities are to be examined.

### G. Judging Managerial Efficiency

The investigator has to judge the efficiency of managerial personnel of the organisation seeking loan.

### H. Examining the Nature of Business

The nature of business of the concerned organisation, the nature of competition in the industry to which the organisation belongs, etc. have to be examined by the investigator.

### I. Verification and Valuation of Assets

The investigator has to verify whether the assets really exist or not. Moreover, he has to look into the valuation of assets to assess whether valuation has been properly done or not.

**J. Examining the Investment**

The list of investments of the organisation seeking loan has to be carefully examined. Further, whether the organisation receives interest or dividend in time from such investment instruments has to be checked.

### 10.6.7 Investigation in Situation of Unusual/Exceptional Decline in Profit

An investigator may be appointed to examine the reasons for unusual/exceptional decline in profit of an organisation. In this case, the procedure of investigation is stated below.

**A. Examining Price of Raw Materials**

The investigator has to verify the price of raw materials to see whether there is any abnormal hike in the price.

**B. Examining Wages**

Whether the organisation is forced to increase the wages of its employees heavily has to be examined.

**C. Looking into Competition**

The nature of competition has to be ascertained so that the investigator can verify whether the organisation is in a position to increase the price of goods.

**D. Verifying 'Stock Clearance' Orders**

Sometimes, sale is effected to clear hugely accumulated stock. In such cases, the investigator has to verify whether such orders come from appropriate authority or not.

**E. Examining Goods Sent on 'Sale or Return' Basis**

The investigator has to examine carefully whether proper recording has been made in accounting with respect to goods sent on 'sale or return' basis.

**F. Verifying Stock Valuation**

The investigator has to verify whether closing stock has been understated or not. Understatement of closing stock reduces profit.

**G. Examining Goods Destroyed**

If goods are destroyed because of fire or accident or other reasons, the investigator has to judge whether insurance claims have been received or not against such loss of goods if the goods are insured.

**H. Examining Purchase Records**

The investigator has to examine the purchase records of the organisation to find out whether any fictitious purchase has been recorded or not.

## SUMMARY

- Investigation is an in-depth examination of books and records for any special purpose. Such examination may involve both financial and non-financial information.
- Investigation is not always compulsory. It is an examination of books and records for any special purpose like to know financial position, earning capacity, prove fraud, invest capital, etc.
- The time horizon of investigation depends upon the requirement. The scope of the investigation is generally limited since it attempts to answer only those questions that are asked in the engagement letter.
- Investigation report is addressed to the party on whose instruction investigation was conducted. The investigator is accountable only to the person who appoints him for conducting investigation.
- Investigation may be carried out to ascertain the causes of low profitability, to examine the causes of high employee turnover, to identify the nature of fraud and the persons involved in fraudulent activities, to judge the creditworthiness of the prospective borrower, to judge the nature and extent of sickness of an organisation and its possibility of revival etc.
- There exist substantial differences between audit and investigation. Audit is usually concerned with *prima-facie* evidence. Investigation is usually concerned with conclusive evidence.
- Investigation is of two types: (a) Non-statutory investigation, and (b) Statutory investigation. Statutory investigation is required as per the provisions of Sections 210, 212, 213 and 216 of the Companies Act, 2013.
- An investigator is appointed to investigate any suspected fraud, to justify whether business combination between two or more organisations should be effected or not, to examine the nature and extent of sickness of an organisation, to determine whether it will be prudent to enter into an existing partnership firm, company to examine whether the claims submitted by the insured in relation to events like fire or other hazards are justified or not, to judge the creditworthiness of the prospective borrower, to examine the reasons for unusual decline in profit of an organisation etc. In such circumstances, the investigator has to draw the outline of his course of action and proceed accordingly so that he can submit the report to the appointing authority in time.

## EXERCISE

### A. Short Answer Type Questions **(2–4 marks)**

1. What do you mean by 'investigation'? [*C.U. B.Com(H), 2014, 2016*]
2. State two features of investigation.

3. Mention two purposes of investigation.
4. State two points of difference between auditing and investigation.

## B. Medium Answer Type Questions (4–6 marks)

1. Discuss the concept of investigation.
2. State the features of investigation. [*C.U. B.Com(H), 2014, 2016*]
3. Explain the purposes of investigation.
4. Distinguish between auditing and investigation.
5. Discuss in brief different types of statutory investigation as per the Companies Act, 2013.
6. How will you investigate misappropriation of cash? [*C.U. B.Com(H), 2013, 2016*]
7. What should be the investigation procedure with respect to misappropriation of goods?
8. How will you investigate manipulation of accounts?
9. Mention the types of investigation with example. [*C.U. B.Com(H), 2014, 2016*]
10. Make a brief outline of investigation about business combinations. [*C.U. B.Com(H), 2014, 2016*]

## C. Essay Type Questions (8–10 marks)

1. Outline the procedure to be adopted for investigating the affairs of an organisation for suspected fraud.
2. Outline the procedure to be adopted for investigation with respect to business combination.
3. Outline the procedure to be adopted for investigating the sickness of an organisation.
4. Outline the procedure to be adopted for investigating the admission of a new partner.
5. Outline the procedure to be adopted for investigating settlement of claims of general insurance companies.
6. Outline the investigation procedure to be adopted before sanctioning/granting loan to an organisation.
7. Outline the investigation procedure to be adopted in situation of unusual/exceptional decline in profit of an organisation.

# 11 CHAPTER — OTHER THRUST AREAS

**CHAPTER OUTLINE**


**11.1** Introduction
**11.2** Cost Audit
**11.3** Management Audit
**11.4** Tax Audit
**11.5** System Audit
**11.6** Social Audit
**11.7** Environmental Audit
**11.8** Propriety Audit
**11.9** Performance Audit
**11.10** Professional Ethics
**11.11** Auditor's Independence
**11.12** Audit under Computerised Information System (CIS) Environment
**11.13** Standards on Auditing


## 11.1 INTRODUCTION

Generally, when we use the term 'audit' it means 'financial audit' or auditing of financial transactions. But now a day, the scope of auditing is not only restricted to financial audit, but also extended to the audit of cost accounts, managerial policies, operational efficiencies, tax compliance, system applications, social implications of business organisations and also environmental aspects. Even non-business organisations avail the services of qualified auditors to get their accounts audited. Again, due to implementation of computer in day to day operation of business, the process of collecting the evidences and their authentication process has also been changed. This chapter carefully discusses all these new areas of audit. In addition this chapter also deals with two important aspects of auditing i.e. professional ethics and Standards on Auditing (SA).

## 11.2 COST AUDIT

### 11.2.1 Concept of Cost Audit

Cost Audit involves an examination of cost books, cost accounts, cost statements and subsidiary and prime documents with a view to satisfy the auditor that these represent true and fair view of the cost of production. This also includes the examination of the appropriateness of cost accounting system.

### 11.2.2 Definition of Cost Audit

According to the Institute of Cost and Management Accountants of England, cost audit represents the verification of cost accounts and a check on the adherence to cost accounting plan. Cost audit, therefore, comprises:

(a) Verification of cost accounting records such as the accuracy of the cost accounts, cost reports, cost statement, cost data and costing techniques, and
(b) Examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

The term 'cost audit' has been defined by the The Institute of Cost Accountants of India as "an independent examination of cost and other related information in respect of a product or group of products of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

So, cost audit may be defined as a system of audit for the review, examination and appraisal of the cost accounting records and documents maintained by the organisation.

### 11.2.3 Objectives of Cost Audit

Cost audit has both general and social objectives. The objectives are summarised below:

***General Objectives***

(i) **Detections of Errors and Frauds** Cost audit ensures that the prescribed procedures of cost accounting records rules are duly adhered to and thereby helps in detection of errors and fraud.

(ii) **Proper Maintenance and Compliance** It aims at verification of cost accounts with a view to ascertaining that these have been properly maintained and compiled according to the cost accounting system followed by the enterprise.

(iii) **Ascertainment of 'Cost Unit' and 'Cost Center'** It ensures verification of the cost of each 'cost unit' and 'cost center' to ensure that these have been properly ascertained.

(iv) **Inventory Valuation** Cost audit helps in inventory valuation.

(v) **Fixation of Price** It also facilitates the fixation of prices of goods and services.

(vi) **Reconciliation of Cost and Financial Accounts** Cost audit ensures periodical reconciliation between cost accounts and financial accounts.

**(vii) Optimum Utilisation of Resources** It ensures optimum utilisation of human, physical and financial resources of the enterprise.

**(viii) Detection of Abnormal Loss** Cost audit helps in detection and correction of abnormal loss of material and time.

**(ix) Cost Consciousness** Cost audit may be introduced to bring cost consciousness among the employees and management of the organisation.

**(x) Inter Farm Comparison** It also advises management, on the basis of inter-firm comparison of cost records, as regards the areas where performance calls for improvement.

**(xi) Promoting Corporate Governance** It promotes corporate governance through various operational disclosures to the directors.

**(xii) Accuracy of Costing Data** Cost audit ensures the accuracy of costing data. This is done by verifying the arithmetical accuracy of cost accounting entries in the books of accounts.

***Social Objectives***

**(i) Reasonable Price** Cost audit facilitates in fixation of reasonable prices of goods and services produced by the enterprise.

**(ii) Improvement in Productivity** It ensures improvement in productivity of human, physical and financial resources of the enterprise.

**(iii) Channelizing Resources** It also ensures channelising of the enterprise resources to most optimum, productive and profitable areas.

**(iv) Escalation Clause** Availability of audited cost data is an important basis as regards contracts containing escalation clauses.

**(v) Settlement of Bill** It also ensures facilitation in settlement of bills in case of cost-plus contracts entered into by the Government.

**(vi) Findings the Areas of Inefficiency** Cost audit ensures pinpointing areas of inefficiency and mismanagement, if any for the benefit of shareholders, consumers, etc., such that necessary corrective action could be taken in time.

### 11.2.4 Advantages of Cost Audit

Cost audit is useful to the management, society, shareholders and the government. The advantages are as under:

**A. To Management**

**(i) Reliable Data Source** Management gets reliable data for its day to day operations like price fixing, control decision making, etc.

**(ii) Check on Wastage** A close and continuous check on all wastages is kept through a proper system of reporting to management.

(iii) **Corrective Actions** Inefficiencies in the working of the company are brought to light to facilitate corrective action.

(iv) **Management by Exception** Management by exception becomes possible through allocation of responsibilities to individual managers.

(v) **Helps in Budgetary Control** The system of budgetary control and standard costing will be greatly facilitated.

(vi) **Valuation of Closing Stock** A reliable check on the valuation of closing stock and work in progress can be established.

(vii) **Detection of Errors and Frauds** It helps in the detection of errors and fraud.

**B. To Society**

(i) **Escape from Exploitation** Cost audit is often introduced for the purpose of fixation of prices. The prices so fixed are based on the correct costing data and so, the consumers are saved from exploitation.

(ii) **Controlling Price** Since price increase by some industries is not allowed without proper justification as to increase in the cost of production or inflation, hence, price hikes can be controlled and consumers can maintain their standards of living.

**C. To Shareholders**

Cost Audit ensures that proper records are kept as to purchases and utilisation of materials and expenses incurred. It also makes sure that the valuation of closing stock and work in progress is on a fair basis. Thus, the shareholders are assured of a fair return on their investment.

**D. To Government**

(i) **Cost Plus Contract** Where the Government enters into a cost plus contract, cost audit helps government to fix the price of the contract at a reasonable level.

(ii) **Pricing for Essential Commodities** Cost audit helps in the fixation of ceiling prices of essential commodities and thus, undue profiteering is checked.

(iii) **Attention on Inefficient Units** Cost audit enables the government to focus its attention on inefficient units.

(iv) **Protection to Certain Industries** Cost audit enables the government to decide in favour of giving protection to certain industries.

(v) **Settlement of Trade Disputes** Cost audit facilitates settlement of trade disputes brought to the government as audited data helps the Government to identify the real facts.

(vi) **Creates a Healthy Competition** Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check in inflation.

### 11.2.5 Importance of Cost Audit

The need for audit of cost accounts is now being growingly felt in industry. It has got vast potentiality particularly in the context of wastage and inefficiency, underutilisation of capacity, low productivity, corporate sickness, rising price and slow pace of economic development. In fact, the thought that the cost audit is superfluous when financial audit is conducted in an organisation, is not at all justified. While financial audit has a great role to play in its respective field, cost audit acts as an effective tool of control in the hands of management. It also renders invaluable services to shareholders, customers, government and to the society at large. The need for audit of cost accounts can be understood from the following services rendered by it:

(i) **Increasing Productivity** Cost audit highlights wastage and inefficiency in the manufacturing operation of the business. It also emphasises on the optimum capacity utilisation. This leads to an improvement in the productivity level of the business.

(ii) **Decision Making** Cost audit provides vital data based on which management can take various policy decisions such as Make or Buy, selection of product mix, pricing policy, etc. So, managerial efficiency is enhanced by cost audit.

(iii) **Utilisation of Resources in Alternative Channels** By showing the best alternative avenues for channeling resources, cost audit increases shareholder's return.

(iv) **Setting of Standard** The audited costs can be used by associations of various industries for compiling standard cost of the product against which the individual firm may compare their actual cost.

(v) **Customer's Benefit** By ensuring efficient and effective utilisation of resources, cost audit enhances value addition. This added value can be enjoyed by all and definitely some portion of it can be passed on to customers by way of reduced price of product.

(vi) **Arresting Corporate Sickness** By creating cost consciousness in the minds of all employees, cost audit can definitely go a long way in reducing the magnitude of industrial sickness now plaguing our economy.

(vii) **Extending Tariff Protection** The government can take decisions regarding extension or abolition of tariff protection based on audited cost structure of various companies.

(viii) **Control Over Monopolistic Price** Very often it is seen that a monopoly firm fixes prices of its product at its whims ignoring customer's interest altogether. This tendency can be curbed by the government based on the audited cost structure of that company.

(ix) **Earning Foreign Exchange** Home industry cannot penetrate into foreign market without quality goods at reduced prices. Cost audit, by ensuring optimum utilisation of resources, can help the industry in this regard.

(x) **Creation of Employment Opportunities** By eliminating wastage and thereby generating additional fund, cost audit helps to make new investment which is the crying need of the country for solving the present unemployment problem.

Cost audit has now passed its embryonic stage. Its importance is now being gradually understood by the captains of industries and also by the government. That is why government

of our country has been gradually bringing important manufacturing as well as servicing industries under the purview of cost audit.

### 11.2.6 Difference between Financial Audit and Cost Audit

| Points of Distinction | Financial Audit | Cost Audit |
|---|---|---|
| Meaning | Financial audit is the audit of financial accounts based on supporting documents and vouchers. | Cost audit is the verification of cost records, cost transactions, cost accounting plans, procedures and techniques. |
| Objective | Its main objective is to express opinion on true and fair view presented by financial statements. | Cost audit is undertaken with a view to expressing opinion on the accuracy of cost records, propriety of transactions and efficiency of performance. |
| Nature | Its main trust is verification of books of accounts. It is not primarily concerned with inefficiency, wastage and leakage of revenue. | It is forward looking in nature. Its main thrust is to bring efficiency in performance and improvement in profitability by identifying the areas of wastage, inefficiency, and ineffectiveness. |
| Compulsion | It is a statutory requirement applicable to all companies. | It is not compulsory for all companies. It is statutorily conducted in companies belonging to those industries as specified by the Central Government. |
| Appointment | Except the first auditor who is appointed by the Board of Directors, the subsequent statutory auditors are appointed by shareholders in the Annual General Meeting. In case of failure of the company to appoint the statutory auditor, the Central Government may appoint the statutory auditor. | He is appointed by the Audit Committee and in the absence of the Audit Committee, by the Board of Directors with the prior approval of Central Government. |
| Qualification | The statutory auditor conducting financial audit must be a Chartered Accountant. | The cost auditor must be a Cost Accountant. |
| Report | The financial auditor submits his report to all the members of the company. | The cost auditor submits his report to the Central Government with a copy to the company. However, the Companies (Cost Records and Audit) Rules, 2014 now requires the cost auditor to submit his report to the Board of Directors of the company. |
| Principles | The financial audit is conducted based on principles as prescribed by auditing standards issued by the Institute of Chartered Accountants of India. | The cost audit is done based on cost auditing standards issued by the Institute of Cost Accountants of India. |

### 11.2.7 Legal Provisions Regarding Cost Audit

Section 148 of the Companies Act, 2013, deals with the issues of maintenance of cost records and auditing of the cost records by the companies. Through this Section Central Government has mandated the maintenance of cost records and audit thereof for specified class of companies.

Accordingly, the Ministry of Corporate Affairs issued Companies (Cost Records and Audit) Rules, 2014 which was made effective from 1.4.2014. But these rules were very complicated and difficult to implement in many large companies because of providing for a stringent threshold in terms of net worth or turnover of companies. So, in order to do away with this situation, the Ministry subsequently issued Companies (Cost Records and Audit) Amendment Rules, 2014 on 31.12.2014. This rule has been superseded by the Companies (Cost Records and Audit) Rules, 2016 on 14.7.2016.

The said rule has divided the list of companies into regulated sectors and non-regulated sectors. Some of the companies/industries/sectors/products/service prescribed under the said rule are given below:

**(i) Regulated Sectors** Telecommunication services, generation, transmission, distribution and supply of electricity, petroleum products, drugs and pharmaceuticals, fertilizers, sugar and industrial alcohol.

**(ii) Non-regulated Sectors** Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item, turbo jets and turbo propellers, arms and ammunitions, propellant powers, prepared explosives, safety fuses, denoting fuses, radar apparatus, radio navigational aid apparatus and radio remote control apparatus, tanks and other armoured fighting vehicles port service, aeronautical services, steel roads and other infrastructural projects, rubber and allied products, coffee and tea, railways or tramway base metal, inorganic chemicals organic chemicals, organic or inorganic compounds of precious metals, jute and jute products, edible oil, construction industry, health service, education services, milk power, insecticides, plastics and polymers, tyres and tubes, paper, textiles, glass, other machinery, electricals or electronic machinery, production import and supply or trading of various medical devices.

### 11.2.8 Companies (Cost Records and Audit) Rules, 2014

This Rules prescribe provisions with respect to Regulated and Non-regulated sectors in six different sections as follows:

Rule-1 Short title and commencement

Rule-2 Definitions

Rule-3 Application of Cost Records

Rule-4 Applicability for Cost Audit

Rule-5 Maintenance of Cost Records

Rule-6 Cost Audit

However, in this section we shall explain only two rules i.e. Rule-3 and Rule-4. This are discussed below:

### A. Rule-3 Maintenance of Cost Records

Rule-3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account. These companies include Foreign Companies defined in Sub-section (42) of Section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise as per the turnover criteria provided under Micro, Small and Medium Enterprise Development, 2006.

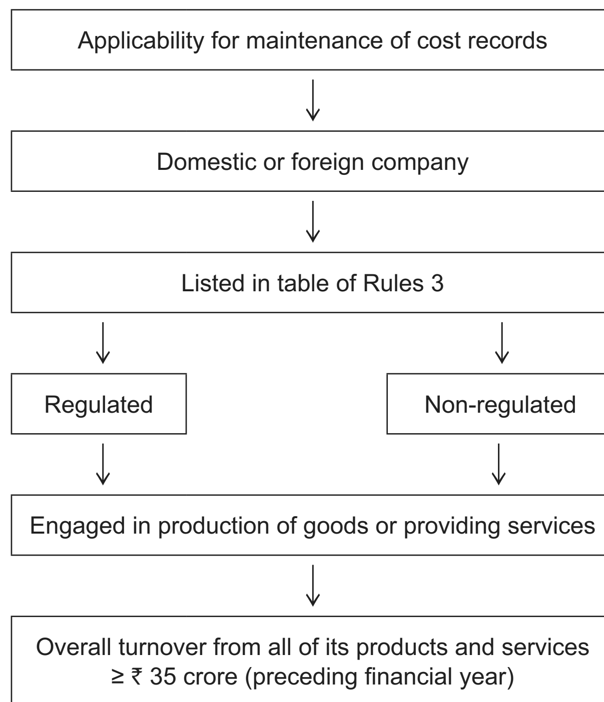


**Fig. 11.1** Diagrammatic Representation

### B. Rule-4 Applicability of Cost Audit

***Rule 4 provides that***

(i) Every company specified as 'Regulated Sector' of Rule-3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is fifty crore rupees or more and the aggregate turnover of the individual product or

products or service or services for which cost records are required to be maintained under Rule-3 is rupees twenty-five crore or more.

(ii) Every company specified as 'Non-regulated Sector' of Rule-3 shall get its cost records audited in accordance with these rules, if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is one hundred crore rupees or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under Rule-3 is thirty-five crore rupees or more.

(iii) The requirement for cost audit under these rules shall not apply to a company which is covered in Rule-3 and–

(a) whose revenue from exports, in foreign exchange exceeds, seventy-five per cent of its total revenue; or

(b) which is operating from a special economic zone.

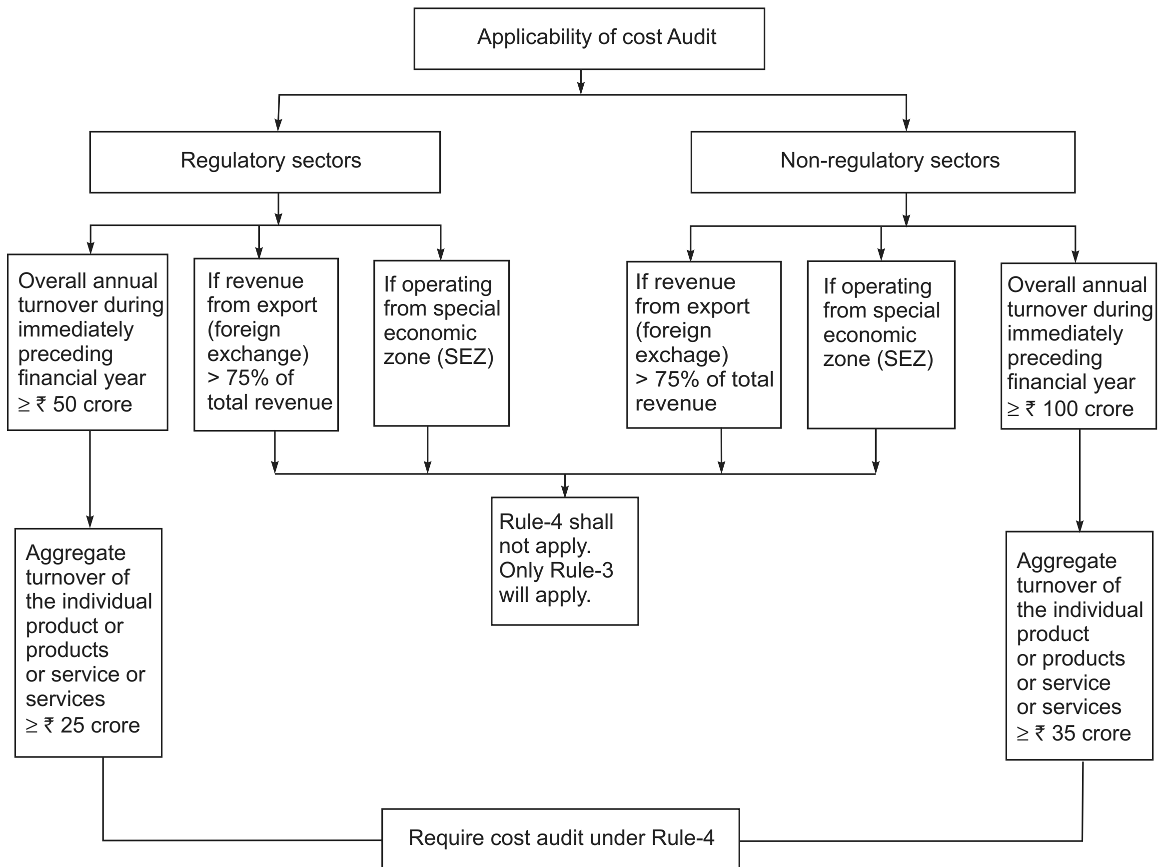


**Fig. 11.2** Diagrammatic Representation

**Applicability of Rule-3 and Rule-4**

| Rule | Description | Turnover limit | |
|---|---|---|---|
| | | Regulated sector | Non-regulated sector |
| Rule-3 | Maintenance of Cost Records | An overall turnover from all its products and services of ₹35 crore or more during the immediately preceding financial year. | An overall turnover from all its products and services of ₹35 crore or more during the immediately preceding financial year. |
| Rule-4 | Applicability of Cost Audit | Overall annual turnover during immediately preceding financial year ≥ ₹50 crore<br>&<br>Aggregate turnover of the individual product or products or service or services ≥ ₹25 crore | Overall annual turnover during immediately preceding financial year ≥ ₹100 crore<br>&<br>Aggregate turnover of the individual product or products or service or services ≥ ₹35 crore |

### 11.2.9 Appointment and Remuneration of Cost Auditor

As per Rule 14 of the Companies (Audit and Auditors) Rules, 2014,

(i) In the case of companies which are required to constitute an Audit Committee–

(a) The Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as the cost auditor on the recommendations of the Audit Committee, which shall also recommend remuneration for such cost auditor,

(b) The remunerations recommended by the Audit Committee under (a) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders.

(ii) In the case of other companies which are not required to constitute an Audit Committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as the cost auditor and the remuneration of such cost auditor shall be ratified by the shareholders subsequently.

### 11.2.10 Qualification, Disqualification, Rights, Duties and Obligations of Cost Auditor

The qualifications, disqualifications, rights, duties and obligations applicable to company auditors shall apply to a cost auditor appointed under Section 148 and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

It may be noted that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

### 11.2.11 Penal Provisions in Case of Default

If any default is made in complying with the provisions of Section 148,

(i) The company and every officer of the company who is in default shall be punishable in the manner as provided in Sub-section (1) of Section 147.
(ii) The cost auditor of the company who is in default shall be punishable in the manner as provided in Sub-sections (2) to (4) of Section 147.

### 11.2.12 Submission of Cost Audit Report

A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in Form CRA-4 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014. If, after, considering the cost audit report referred to under this section and the information and explanation furnished by the company as above, the Central Government is of the opinion that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

### 11.2.13 Annexure to Cost Audit Report

Annexure has been reclassified into four parts as under:

**Part A**

(i) General Information
(ii) General Details of Cost Auditor
(iii) Cost Accounting Policy
(iv) Product/Service Details – for the company as a whole

**Part B (For Manufacturing Sector)**

(i) Quantitative Information
(ii) Abridge Cost Statement
(iii) Details of Material Consumed
(iv) Details of Utilities Consumed
(v) Details of Industry Specific Operating Expenses

**Part C (For Service Sector)**

(i) Quantitative Information

(ii) Abridge Cost Statement
(iii) Details of Material Consumed
(iv) Details of Utilities Consumed
(v) Details of Industry Specific Operating Expenses

**Part D**

(i) Product and Service Profitability Statement
(ii) Profit Reconciliation
(iii) Value Addition and Distribution of Earnings
(iv) Financial Position and Ratio Analysis
(v) Related Party Transactions
(vi) Reconciliations of Indirect Taxes

## 11.3 MANAGEMENT AUDIT

### 11.3.1 Concept of Management Audit

Management Audit is the total examination of transaction of an organisation, or parts of it, and includes checks on the effectiveness of managers, their compliances with company on professional standard, the reliability of management date, the quality of performance of duties and recommendations for improvement. In this context, management audit undertakes examination of the effectiveness of management in controlling the total activities of the organisation in the accomplishment of the organisation objectives. Management audit deals with:

(i) The objectives of an organisation;
(ii) The policies and procedures in terms of the objective of the organisation; and
(iii) Adequate performance of an organisation in terms of objectives, policies, and procedures.

### 11.3.2 Definition of Management Audit

Management audit is the unique process appraising the performance of directors, managers or in other words, appraising the performance of the management. It is normally presumed to be a non-routine investigation into a performance of a manager or group of managers. But in a number of organisations management audit is now a regular feature to examine and improve managerial effectiveness.

It attempts to look into all aspects of the management performance. Management audit does not concentrate on financial matters alone as in the case of financial audit. It looks into the efficiency and effectiveness of performance in an organisation.

However, there is no general agreement as to the precise meaning of the term “management audit”. The term has been defined by different authorities differently.

**William P. Leonard** "Management audit may be defined as a comprehensive and constructive examination of an organisation structure of a company and its plans and objective, its means of operation and its use of human and physical facilities."

**Leslie Howard** "Management audit may be more specifically defined as being an investigation of a business from the highest level downwards in order to ascertain whether sound management prevails throughout, thus facilitating the most effective relationship with outside world and the most efficient organisation and smooth running internally."

**CIMA Terminology** "Management audit is an objective and independent appraisal of the effectiveness of the managers and effectiveness of the corporate structure in the achievement of company objectives and policies. Its aim is to identify existing and potential management weaknesses within an organisation and to recommend ways to rectify these weaknesses."

Thus, management audit is concerned with evaluation and appraisal of the control system and information in the entire or in various segments of the organisation. Its scope has been widened to appraise in details the systems and subsystems, procedures, job-description and assignment, authorisation, accountability, quality of personnel, quality of information generation, etc.

### 11.3.3 Objectives of Management Audit

The objectives of management audit are to:

- (i) appraise the management performance at all the levels;
- (ii) spotlight the decision or activities, that are not in conformity with organisational objectives;
- (iii) ascertain that objectives are properly understood at all levels;
- (iv) ascertain that controls provided at different levels are adequate and effective in accomplishing management objectives or plans of operations;
- (v) evaluate plans which are projected to meet the objectives;
- (vi) review the company's organisational structure, i.e., assignment of duties; and responsibilities and delegation of authority.

### 11.3.4 Importance of Management Audit

Management audit is now becoming more popular everywhere. Almost all progressive organisations undertake voluntary management audit due to its benefits as under:

- **(i) Framing Policies** It helps management in framing basic policies for the organisation and to define objectives.
- **(ii) Preparing Plan** In pursuance of the objectives of the organisations, management audit helps in preparing a viable and achievable plan for the organisation.
- **(iii) Implementing Plan** It helps in setting up an organisational framework to implement the plans.

(iv) **Designing System** It assists in designing systems and procedures for smooth operations of the organisation.

(v) **Reviewing MIS** It helps in designing and reviewing management information system (MIS) for decision making to help in coordination, motivation and control of the operations.

(vi) **SWOT Analysis** It assists in analyzing SWOT (strengths, weaknesses, opportunities and threats) of the organisational and assists in marketing the organisation stronger.

(vii) **Help Government in Developing Country** In a developing country like India, management audit through CAG, public accounts committee and parliamentary committee on public undertakings, has helped the Government in identifying improper or wasteful use of funds, checking extravagant organisation practices and curving ineffective use of physical resources.

(viii) **Monitoring Sick Industry** Indian financial institutions, banks and Board for Industrial Financial and Reconstruction (BIFR) have found management audit (called concurrent audit) useful in monitoring sick industrial units and to help the units in their rehabilitation.

(ix) **Cost Minimisation** The Railways of India have subjected their finances to open discussion by public to improve resource mobilisation, reduce cost of operations and conserve their scarce resources which are main objectives on management audit.

(x) **Social Cost Benefit Analysis** It can help in analysing social-cost benefit analyses for public projects like dams, power houses, national highways.

(xi) **Amalgamation and Merger** It is essential whenever a unit is planned to be taken over or an amalgamation or merger with other unit is proposed.

(xii) **Future Prospect** Growing number of professional managers, the continuing separation of ownership from management, the wider distribution of stockholders, increasing competition and sickness in industry will sooner or later make certified management audit compulsory just as financial audit has become statutory.

### 11.3.5 Scope of Management Audit

The scope of management audit extends over all the functions of an organisation viz. management, personnel, administration, material administrations, marketing, finance, etc. wherever the effectiveness of management needs to be examined.

Accordingly, the scope of management audit may includes:

(i) The suitability, practicability and present compliance or otherwise of the organisation with its desired objectives and aims.

(ii) The current image of the organisation among customers, general public within its own particular industrial or commercial field.

(iii) Efficient utilisation of resources of the organisation.

(iv) The rate of return of investors' capital—whether poor, adequate or above average.
(v) Relationship of the business with its own shareholders and investing public in general.
(vi) Employee relation.
(vii) The aims and effectiveness of management at its various levels such as top level, middle level, and operational level.
(viii) Financial policies and control relating to production, sales and distribution and in other functions of the organisation.

### 11.3.6 Limitations of Management Audit

Management audit has got the following limitations:

(i) It is very expensive as it is generally done by a team of highly specialised persons whose fees are often very high. So, a small firm cannot afford it.
(ii) Management has to take decisions in uncertainty when sufficient information may not be available. So, if this constraint of management is not kept in mind, and criticism is levelled against them for no fault of theirs, management audit will have dampening effect on the functioning of management.
(iii) As management plans and policies are subject to review, they tend to become file minded rather than action minded. So, instead of increasing the profitability of the business, management audit may cause a fall in profit by making the management inactive.

### 11.3.7 Features of Different Types of Audit

| Ingredients | Management Audit | Internal Audit | Financial, Cost and other Audits |
|---|---|---|---|
| Expectations | Appraising management | Assisting management to identify problems | Specific under statutory and other's directions |
| Attitudes | Friend, philosopher and guide | Policeman/judge | Watch dog/judge |
| Agency | Outside team or management | Internal or external | Specially designated persons |
| Force | Voluntary | Statutory in some cases | Statutory/ Voluntary |
| Area | Complete management or specific problems | Mainly past/procedural | Specific objectives |
| Evaluation | Effectiveness/Quality of management/Policies | Quality of procedures operations/data | Specific information |
| Period covered | Past, present and future | Past and present | Mainly past |
| Procedures | Flexible | Structured | Highly structured |
| Reporting level | Higher | Operational | Designated |
| Time span | Futuristic | Current and immediate | Current and immediate past |
| Periodicity | Regular | Regular | Annual |

### 11.3.8 Conducting a Management Audit

Once the top management has decided on the scope, the staffing, and the frequency of the management audit, the next phase is undertaking the actual audit. This involves investigating and analysing the present facts through interviews as well as completing a management questionnaire so as to determine the problems confronting the organisation.

#### A. Getting the Facts Through Interview

First of all the management auditor should know the information desired for his audit work and as per that requirement he should ask for a number of direct questions to get desired information. Reference can be made to the management audit questionnaire for specific questions. Care must be taken in selecting the proper managers to interview so as to obtain pertinent information. The exchange between auditor and manager should be friendly and conducted in an open atmosphere so as to encourage a free exchange of ideas. The tentative solution provided by the managers should be listened carefully and the auditor should try to include the solutions in his final recommendations so as to experience less oppositions.

#### B. Measuring Performance Through the Management Audit Questionnaire

During the interview, the management auditors make a careful inquiry into important fats. The next step is to analyse this information, with the aim of measuring current performance. The best way to perform such an analysis is to utilise the sections of the management audit questionnaire that apply to the areas under study. A questionnaire is designed to evaluate management practices. There are three possible answers to be management audit questions 'yes' or 'no' and 'N.A.' (not applicable). A 'yes' answer indicates that the specific area, function, or aspect under study is functioning in an acceptable manner; no written explanation is needed in that case. On the other hand, a 'no' answer indicates unacceptable performance and should be explained in writing. Questionnaire comments on negative answers not only provide documentation for future reference, but, more important, provide background information for undertaking remedial action. Those questions that are not applicable and should be ignored in the audit are checked in the 'N.A.' column.

### 11.3.9 Management Audit Report

Management audit report will inevitably cover a wide variety of subjects, reflecting the many and ever increasing ramifications of management audit departments. However, reports may broadly be divided into four categories.

(i) Reports prepared by the management audit staff after their visits to a unit.
(ii) Periodical reports prepared by senior members of management audit department which summarise the main audit findings and recommendations for the period under consideration and which afford a concise review of the department's activities for that period.
(iii) Reports on the results of special investigations and inquiries.
(iv) An annual audit report.

The right of the management auditor to report to the highest level is now well established in many organisations but in all cases responsible officials of the different units which have been subjected to audit should be afforded the opportunity of discussing matters in the report concerning their departments before this is passed in final form to a higher level.

### 11.3.10 Difference between Cost Audit and Management Audit

| Points of Distinction | Cost Audit | Management Audit |
|---|---|---|
| Definition | Cost audit is the verification of the correctness of cost records and adherence to the cost accounting principles, plans and procedures. | Management audit is constructive and comprehensive appraisal and examination of organisation structure of a concern, its plants, means of operation and use of resources. |
| Auditor's qualification | As per Sub-section (3) of Section 148 of the Companies Act, 2013, only a cost accountant in practice is eligible to conduct cost audit. | Management auditor need not necessarily be a qualified accountant. A person with special ability and knowledge can conduct management audit. |
| Objective | Its main objective is to ascertain the reliability and fairness of cost records and cost statements. | The objective of management audit to see whether the company is being run efficiently or inefficiently, prudently or imprudently and to show ways and means of improvement of performance. |
| Periodicity | Cost audit, if ordered by the Central Govt. is to be conducted for the particular year specified in the order. | Management audit is not done for nay such fixed period. It may cover from one to three or four years. |
| Compliance with standards | As per Sub-section 3 of Section 148 of the Companics Act, 2013, Cost Audit has to be conducted in compliance with Cost Auditing Standards issued by the Institute of the Cost Accountants of India. | There is no such standard for conducting management audit. |
| Statutory provision | Cost audit is conducted as per Section 148 of the Companies Act, 2013 in various sector classified as Regulated Sector and Non-regulated Sector. | There is no such provision of management audit in the Companies Act. It is done as per the requirement of management. |
| Reporting | The cost audit report is first submitted to the Board of Directors in Form CRA-3 which will within a period of 30 days from the date of its receipt forward the same to the Central Government along with full information and explanation on every reservation or qualification made by the cost auditor in Form CRA-4. | As management audit is conducted at the behest of management, its report is submitted to the management for their perusal and taking corrective actions. |
| Coverage | Cost audit is mainly concerned with production or service function. | Management audit may cover all important areas of the organisation, namely, Production function, Administrative function, Marketing, etc. |

### 11.3.11 Difference between Financial Audit and Management Audit

| Points of Distinction | Financial Audit | Management Audit |
|---|---|---|
| Nature | Financial audit is concerned with truthfulness of financial statements. It does not bother about profit or loss of the business. It only tries to ensure that financial effect of all events having taken place in the business are properly reflected in the financial statements. | Management audit is concerned with soundness and efficiency of management plans, policies and procedures. |
| Objective | The objective of financial audit is to cater to the information needs of various outside partied related to the business, namely shareholders, investors, creditors, etc., so that based on these information they can safeguard their interest in the business. | Management audit on the other hand, aims at maximising profit or minimising loss of the business by pinpointing management deficiencies in various key areas. It is forward looking and is concerned with future performance improvement. |
| Use of rules | Financial audit is conducted based on auditing standards as prescribed by the Institute of Chartered Accountants of India. | Management audit is not bound by any prescribed rules and procedures. |
| Statutory provision | As per Companies Act, the financial audit of accounts of a company is compulsory. | Management audit is not statutorily compulsory. It depends upon the perception and attitude of management. |
| Periodicity | Financial audit is conducted separately for each accounting year covering the span of twelve months. | There is no hard and fast rule regarding period to be covered under management audit. It may range from one to three or four years. |
| Rendering advice | It is not the duty of the financial auditor to give any advice to management or shareholders. Only when he is specifically requested to give advice on some matter, he can do so. | It is the duty of the management auditor to give advice to the management regarding elimination of management deficiency and performance improvement. |
| Qualification of auditor | A person will be eligible to conduct financial audit of a company, if he is a Chartered Accountant and holds a certificate of practice. Unless he is a Chartered Accountant and holds certificate of practice, he cannot conduct audit whatever may be his intelligence or knowledge in auditing and accountancy. | A management auditor need not be a Chartered Accountant. What is required in this case is that he must be tactful, methodical, analytical and well versed in accounting, auditing, economics, law taxation and other related subjects. |
| Submission report | The financial auditor submits his report to the shareholders as he is appointed to protect their interest along with other outside parties. | The management auditor always submits his report to the management only. |
| Auditor's liability | As the financial audit is a statutory necessity, the auditor who has conducted this audit may be criminally prosecuted under the Companies Act for misfeasance of duty. | Management auditor cannot be criminally prosecuted under the Companies Act for any misfeasance of duty. |

## 11.4 TAX AUDIT

### 11.4.1 Concept of Tax Audit

The Income-tax Law requires the taxpayer to get the audit of the accounts of the business or profession from the view point of Income-tax Law. With this objective, the Income Tax Act, 1961 has contained a number of provisions requiring tax audit of an entity. Tax audit can be defined as "an examination of financial records to assess correctness of calculation of taxable profit, to ensure compliance with provisions of the Income Tax Act and also ensure fulfillment of conditions for claiming deductions under Income Tax Act." Section 44AB gives the provisions relating to the class of taxpayers who are required to get their accounts audited by a chartered accountant. The audit under Section 44AB aims to ascertain the compliance of various provisions of the Income-tax Law and the fulfillment of other requirements of the Income-tax Law.

### 11.4.2 Objectives of Tax Audit

(i) **Reporting Requirement** One of the objectives of tax audit is to report the requirements of Form Nos. 3CA/3CB and 3CD.

(ii) **Ensuring Proper Maintenance of Books and Record** Apart from reporting requirements of Form Nos. 3CA/3CB and 3CD, a proper audit for tax purposes would ensure that the books of account and other records are properly maintained, that they faithfully reflect the income of the taxpayer and claims for deduction are correctly made by him. Such audit would also help in checking fraudulent practices.

(iii) **Save the Time of Assessing Officer** It can also facilitate the administration of tax laws by a proper presentation of accounts before the tax authorities and considerably save the time of Assessing Officers in carrying out routine verifications, like checking correctness of totals and verifying whether purchases and sales are properly vouched for or not. The time of the Assessing Officers saved could be utilised for attending more important and investigational aspects of a case.

### 11.4.3 Tax Auditor

As per Section 44AB(i), the tax audit is to be carried out by an "accountant".

For the purposes of this section, "accountant" shall have the same meaning as in the explanation under Sub-section (2) of Section 288.

The above-mentioned explanation reads as under:

"Accountant" means a chartered accountant within the meaning of Chartered Accountants Act, 1949 (38 of 1949) and includes, in relation to any State, any person, who by virtue of the provisions of Sub-section (2) of Section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an auditor of companies registered in that State.

In simple words, tax audit can be carried out by a Chartered Accountant as defined by the Chartered Accountant Act, 1949.

### 11.4.4 Types of Tax Audit

Tax audit under the Income Tax Act can be broadly summarised under the following three heads:

(i) Compulsory tax audit under Section 44AB
(ii) Tax audit for various deductions and exemptions
(iii) Selective tax audit under Section 142(2A)

### 11.4.5 Provisions of Income Tax Act, 1961 for Tax Audit u/s 44AB

#### A. Applicability

(i) The person is carrying on business and his total sales/turnover exceeds ₹1 crore (Limit increased w.e.f. 1st April, 2012), or
(ii) The person is carrying on the profession, and his gross receipts exceed ₹ 50 lakh (Applicable from the financial year 2016–17 onwards), or
(iii) The person is carrying on business or profession and is covered under the provisions of Section 44AD, 44AE, 44AF, 44BB or 44BBB and claims that his income from the said business is lower than the deemed profits and gains computed under the relevant section.

The due date of filing the tax audit report under Section 44AB is 30th September. For all other assessees who are not liable to get their tax audit done under Section 44AB, the due date of filing of income tax return is 31st July.

#### B. Qualification to Conduct Tax Audit

The audit shall be conducted by an accountant as explained u/s 288 of the Income Tax Act, 1961. This section defines accountant as follows:

(i) A chartered accountant within the meaning of the Chartered Accountants Act, 1949 holding certificate of practice.
(ii) Auditor of a company under Section 266(2) of the Companies Act.

It is to be noted that by virtue of a resolution of the Council of the Institute of Chartered Accountants of India, with effect from 01.04.2005, a member in part time practice is not entitled to perform tax audit.

#### C. Disqualification of Tax Auditor

(i) A chartered accountant who has written the books of the assessee.
(ii) A chartered accountant who is an employee of the assessee or of a concern under the same management.

(iii) Internal auditor who is an employee of the company.

**D. Removal of Tax Auditor**

There is no specific procedure for removal of the tax auditor u/s 44AB of the IT Act. However, he can be removed by the Management for a valid ground, e.g., delay in submission of report.

**E. Ceiling on the Number of Audits**

(i) A chartered accountant shall not accept more than 45 tax audit assignments in a financial year.
(ii) In case of partnership firm, the specified number of 45 tax audit assignments shall be counted for every partner of the firm.

**F. Tax Audit Report e-filing**

The chartered accountant conducting the tax audit is required to give his findings, observation, etc., in the form of an audit report. The report of tax audit is to be given by the chartered accountant in Form Nos. 3CA/3CB and 3CD.

As per Notification No. 34 dated 1$^{st}$ May, 2013, e-filing of the tax audit report is not mandatory from the assessment year 2013–14 onwards.

As per Rule 6G, tax audit report is to be furnished in Form 3CA and Form 3CB and the particulars required to be furnished along with these tax reports should be in Form 3CD.

(i) Form 3CA & Form 3CD: These Forms are used in case where the accounts of the business or profession of a person have already been audited under any other law.
(ii) Form 3CB & Form 3CD: These Forms are used in case where the accounts of the business or profession have not been audited earlier.

**G. Changes in Tax Audit Reporting**

Several changes in tax audit report have been introduced vide Income Tax (7$^{th}$ Amendment) Rules, 2014 which are applicable from the AY 2014-15 onwards. CBDT has amended Form 3CA, Form 3CB and Form 3CD now require explicit mention of the observations/qualifications if any, by the auditor while issuing the true and correct audit report.

With the introduction of these changes, the tax auditor's responsibilities to report detailed information under the new/amended clauses have increased significantly. In case an assessee is liable to get his accounts audited by an accountant under any other law for the same accounting period, the assessee is not mandatorily required to get his audit done again and is only required to submit a report in the form mentioned below. However, if the accounting year is different from the accounting year for which the audit was done under any other Act, the tax audit would be required to be conducted again as per in the Income Tax Act (Circular No. 561 dated 22.05.1990 issued by CBDT).

**H. Penalty for Non-compliance of Section 44AB**

Non-compliance of the provisions of this Act shall attract penalty under Section 271B of the Income Tax Act. If any person required to get his audit done under Section 44AB fails to do so before the specified date, he shall be liable for a penalty of ½% of the turnover/gross receipts subject to a maximum penalty of ₹ 1,50,000.

However, Section 273B states that no penalty shall be levied under Section 271B, if there is a reasonable cause for such failure. Some instances which have been accepted by the tribunals/courts as reasonable causes are:

(i) Registration of the tax auditor and consequent delay
(ii) Death or physical inability of the partner in charge of the accounts
(iii) Labour problems such as strikes, lock-outs for a long period
(iv) Loss of Accounts because of fire/theft, etc. beyond the control of the assessee
(v) Natural calamities

### 11.4.6 Selective Tax Audit under Section 142(2A) of Income Tax Act

The audit conducted under Section 142(2A) of Income Tax Act, 1961 is called selective tax audit. The following important provisions of this section can be noted:

(i) When the assessing officer is of the opinion that it is necessary to get the accounts of the assessee audited in view of the nature or complexities of the accounts or in the interest of the assessee, he may direct the assessee to get his accounts audited by an accountant.
(ii) The accountant conducting selective tax audit shall be nominated by the Commissioner of Income Tax.
(iii) The audit report for selective audit should be made in the form as prescribed under Section 142(2A) in Rule-14A of the Income Tax Rules, 1962.
(iv) The selective tax audit u/s 142(2A) may be required to be conducted even if the accounts have been audited under any other law including Section 44AB of the Income Tax Act, 1961.
(v) The remuneration and expenses payable to the auditor will be fixed by the Commissioner and will be paid by the concerned assessee. If the assessee defaults in making such payments, it will be recoverable as arrear of tax.

## 11.5 SYSTEM AUDIT

### 11.5.1 Concept of System Audit

Traditionally most of our information and data processing needs were fulfilled manually; however, today computers play a large part in assisting us to process data and to take decisions. In today's business world, Information Technology and financial reporting environment are becoming complex. At the same time greater reliance is being placed on the information

generated by the systems. In the process, more and more of business processes have been brought under the purview of systems based on information technology. There has been an increase in complexity by several orders of magnitude. The arrival of the World Wide Web and the shift of traditional computer systems into their 'web-based' avatar have only added new dimensions in the form of threats to security. All these necessitated the introduction of a formal audit technique to ensure integrity, which is known as System Audit.

### 11.5.2 Definition of System Audit

Systems audit or Information systems auditing is the process of collecting and evaluating evidence to determine whether a computer system safeguard assets, maintains data integrity, allows organisational goals to be achieved effectively, and uses resources efficiently. Information systems audit has been focused on whether the systems safeguard the assets, maintain data integrity, and facilitate the achievement of objectives of the company. An information system audit is an examination of the management controls within an information technology infrastructure.

Management should be primarily interested in information system audit in order to prevent excessive time and development cost, unrealistic or impossible objectives to comply with, rigid systems when they become operational, non-compliance with value added benefits and costly methods and systems.

### 11.5.3 Objectives of System Audit

The system audit is done to safeguard the asset of the organisation, improving the efficiency and effectiveness of the organisation, etc. These objectives are discussed below:

#### A. Safeguarding Asset

The information system assets of an organisation include hardware, software, facilities, people (knowledge), data files, system documentation, and supplies. These assets are often concentrated in one or a small number of locations, such as a single disk. As a result, asset safeguarding becomes an especially important objective for conducting system audit.

#### B. Data Integrity

Data integrity is a fundamental concept in information systems auditing. It is a state implying data has certain attributes—completeness, soundness, purity, and veracity. If data integrity is not maintained, an organisation no longer has a true representation of itself or of events.

#### C. Increasing Effectiveness of the System

An effective information system accomplishes its objectives. Evaluating effectiveness implies knowledge of user needs. Management requests for a post audit to determine whether the system is achieving its stated objectives. The evaluation provides input to the decision on whether to scrap the system, continue running it, or modify it in some way.

### D. Improving System Efficiency

An efficient information system uses minimum resources to achieve its required objectives. Information systems consume various resources—machine time, peripherals, system software, and labor. These resources are scarce, and different application systems usually compete for their use. So, system audit is done to improve the efficiency of the system.

### E. General Objectives

The general system auditing objectives are as follows:

(i) Validation of the organisational aspects and administration of the information service function.
(ii) Validation of the controls of the system development life cycle.
(iii) Validation of the access controls to installations, terminals, libraries, etc.
(iv) Automation of internal auditing activities.
(v) Internal training.
(vi) Training the members of the information service function department.

## 11.5.4 Scope of System Audit

The scope of systems audit covers the entire Information System (IS) management process. The scope includes:

**(i) Review the System** The system audit comprises the review of the entire design and development process, the review of technology choice, the processes employed to assess risks and losses that could accrue to the system, the possibility of computer frauds, the care taken in managing changes to the system, extent of testing and reliability of the system.

**(ii) Coverage** It also covers senior management involvement, review applicable minutes network, workstation, Internet, disaster recovery, and other IT security policies.

**(iii) Components and Functions** System audit further covers overall security procedures, segregation of IT duties, internal quality and integrity controls, data communication security, user identification authorisation, user level of accessibility, restricted transactions, activity and exception reports, backup procedures, other operational security controls, insurance coverage, network security including the internet, internal auditing procedures, contingency planning and disaster recovery, internet security procedures, vendor due diligence, etc.

## 11.5.5 Advantages of System Audit

The advantage of systems audits is sharply highlighted by the way businesses are changing. For many business (for profit or for nonprofit) to survive, it must have an adequate information system in place. To know whether a system is secured or not an audit is carried out on the system. The system audit is mainly getting importance for various reasons but few are explained as below:

**(i) It Ensure the Security of Information** By information security audit, the activities of actors in the information domain need to be monitored more than ever. The advent of mobile computing and smartphone created a new loophole in the business of handling information which the information audit must track down and offer solution to.

**(ii) Filter out Noise in the System** Noise in any information system is a key factor that causes mistakes, misunderstandings and misrepresentation of facts which has proved to be fatal over the period of time. It is by auditing the system that carries the information flow that such noises are identified and corrective action taken to either remove or ameliorate their effects on the organisation.

**(iii) Building Confidence and Public Reputation** This is a rational thing to do as the number one tenet of investing and financial management is to ensure the safety of capital. The general idea behind any form of auditing of any kind is to render credibility to a piece of information.

**(iv) Improve General Economy** The role of information auditing also includes improving the general standard of living in an economy. Through adequate information audit, threats to properties are identified and removed if possible.

## 11.6 SOCIAL AUDIT

### 11.6.1 Concept of Social Audit

Business is a social institution and evolves out of the social environment. In course of earning profit, business takes resources from society and so, in return the they should discharge certain duties to society also for long term sustainability. In order to measure and examine how far the business concerns have been able to discharge their social responsibility, that is, how much contribution has been made by the concern towards social welfare, the concept of 'social audit' was introduced in business arena.

### 11.6.2 Definition of Social Audit

The term 'Social Audit' has been defined as a process that allows any organisation to assess its social impact and ethical performance vis-à-vis its stated vision, mission and goals. It helps the organisation to set up measurement criteria for its social impact, account for its social performance, report on that performance and draw up action plans to improve that performance. The 'organisation' being discussed here could be a corporate body, government agency or any other agency whose actions or decisions have a social consequence. The scope of social audit is not merely restricted to corporate decisions or actions that have a 'social focus'.

As per *Calendonia Centre for Social Development, United Kingdom–*

'Social Auditing' is a process that enables an organisation to assess and demonstrate its social, economic, and environmental benefits and limitations. It is a way of measuring the extent to which an organisation lives up to the shared values and objectives it has committed itself to.

Social auditing provides an assessment of the impact of an organisation's non-financial objectives through systematically and regularly monitoring its performance and the views of its stakeholders.

**Differences between Social Auditing, Operational Auditing and Financial Auditing**

| Point of Distinction | Financial Auditing | Operational Auditing | Social Auditing |
|---|---|---|---|
| **Scope** | It involves audit of financial statements and transactions. | It involves measuring the operations and processes of any entity against established operational standards and suggesting ways and means to improve adherence to standards. | It looks at the impact caused on the society by the organisation. |
| Coverage | Coverage of non-financial matters limited only to those aspects that provide additional information to stakeholders of the business who are mainly interested in the financial status of the entity. | It might also involve suggestions for resetting the operational standards based on the experiences of the entity with respect to its environment. | It takes an 'outside-in' approach of looking at organisation, dealing more with how the non-financial stakeholders view the business rather than how the managers/owners of the organisation plan it to be. |
| Objective | Financial audit is done keeping in mind the objective of issuing an opinion on the state of financial of affairs. | Operational auditing is done basically to report on operational inefficiencies. | Social audit is done to examine the social responsibilities and obligation of the organisation. |
| Deals with | It deals with study of financial data. | It deals with the study of operational parameters of the organisation. | It deals with the study of social impact parameters, most of which can be gathered from outside the organisation which is being audited. |

### 11.6.3 Objectives of Social Audit

The broad objectives of any social audit engagement are as follows:

(i) **To Meet Social Objectives** Social auditing helps to assess the physical and financial gaps between needs and resources available to meet targeted social objectives.

(ii) **Creating Awareness** Social audit creates awareness among beneficiaries and providers of social and productive services.

**(iii) Development Programme** It increases efficacy and effectiveness of development programmes.

**(iv) Scrutiny of Policy** It ensures scrutiny of various policy decisions, keeping in view stakeholder's interests and priorities, particularly of marginal sections of the society.

**(v) Estimation of Opportunity Cost** It also ensures estimation of the opportunity cost for stakeholders of not getting upon timely access to public services.

The specific objectives of social audit engagements will, however, depend upon the context of audit.

### 11.6.3 Advantages of Social Audit

There are several benefits that social audit can bring to an organisation. Some of them are as follows:

**(i) Helps in Policy Decision** Based on the social audit findings, the policymakers of the organisation could re-strategise for course corrections to ensure that its social impact is as intended.

**(ii) Improve Credibility** Social audit enhances the credibility of an organisation with its stakeholders. For a corporate enterprise, it could mean enhancement of the brand image which could result in higher equity with stakeholders. In case of a positive report from the social audit, the value added to the owners' financial capital could far outweigh the auditing cost incurred.

**(iii) Tool for Risk Management** Organisations can better manage its risks, as it can enhance its social focus by covering any adverse social impacts highlighted by it in a social audit report.

**(iv) Support from Stakeholders** Organisations that emerge with a positive social impact through their objectives and actions tend to have a higher sustainability as they enjoy the support of the social environment in which they operate.

### 11.6.4 Social Auditing in India

Social auditing in India can be viewed from two aspects i.e. social auditing in Government Sector and social auditing in Corporate sector. These are discussed below:

#### A. Government Scenario – CAG's Audit and Social Audit

The Central and the State Government agencies institute several programmes from time to time under their development initiatives. These programmes need Monitoring and Evaluation systems to ensure that the resources that have been allocated are used in the right manner to yield the desired results. 73rd amendment to the Indian Constitution empowered the Gram Sabhas to conduct Social Audit. Right to Information Act, 2005 is also a key pillar of support for social audit system in India.

Comptroller and Auditor General of India (CAG) has conducted performance audits of most of the key socio-economic programmes of the Government of India e.g. National Rural Employment Guarantee Scheme (NRGRES), National Rural Health Mission (NRHM), Sarva Shiksha Abhiyan (SSA), Mid-day Meals Scheme, Accelerated Rural Water Supply Programme (ARWSP) and Pradhan Mantry Gram Sadak Yojana (PMGSY).

**B. Corporate Scenario**

So far as the corporate sector of India is concerned, it is largely voluntary action that has driven a large Indian corporation to publish details of their social accountability as part of their Annual Report. Corporates like ITC Ltd., Uniliver are some of the examples. ADITYA Birla Group also discloses in its portal its plan and monitors its social projects.

The adoption of standards is the first step towards institutionalisation of Social Accounting. Irrespective of regulatory requirements, Indian corporates have a clear case to adopt voluntary Accounting and Reporting Standards on Social Performance to enhance their equity in the investor community. Indian corporate belonging to similar industries (that tend to have similar Social and Environmental impacts) can adopt common standards in these areas so that it is efficient and effective for Social Auditors to assess their performance using those standards. The corporate sector also has a specific role to play in the demand side of Social Auditing.

## 11.7 ENVIRONMENTAL AUDIT

### 11.7.1 Concept of Environmental Audit

According to Environment (Protection) Act, 1986, "Environment includes water, air and land and the inter relationship which exist among and between water, air and land, human beings, other living creatures, plants, micro-organism and property." Environments have been severely affected due to industrialisation throughout the last century. Industry, which is the major source of green house gases (GHGs) have been identified as one of the main reasons for global warming. In this background, environment audit is an excellent management tool to assess the activities of an industry from the viewpoint of pollution and measure the efficiency and the adequacy of control measure.

The term environmental audit means different things to different people. Terms such as environmental assessment, survey and review are used to describe the same type of activity. Furthermore, some organisations consider that an 'environmental audit' addresses only environmental matters, whereas others use the term to mean an audit of health, safety and environmental matters. Basically, environmental audit is an independent evaluation of policy and principles, systems procedures, practices and performance, and other elements of a business relating to environment.

### 11.7.2 Definition of Environmental Audit

Some important definitions of environmental audit are as follows:

(i) The Confederation of British Industry (1990) defines environmental audit as, "the systematic examination of the interaction between any business operations and its surroundings. This includes all emissions to air, land and water; legal constraints; the effects on the neighbouring community, landscape, and ecology; and the public's perception of the operating company in the local area. Environmental audit does not stop at compliance with legislation. Nor is it a green washing public relation exercise. Rather it is a total strategic approach to the organisation's activities."

(ii) The International Chambers of Commerce (ICC) in its publication Environmental Auditing (1989) defines environmental auditing as "a management tool comprising a systematic, documented, periodic and objective evaluation of how well environmental organisation, management and equipment are performing, with the aim of helping safeguard the environment by:

(a) Facilitating management control of environmental practices; and
(b) Assessing compliance with company policies which would include meeting regulatory requirements."

Hence, environmental audit may be defined as a means of management which allows exhaustive, documented, periodical and objective evaluation of the way in which management and equipment of an entity manage and control their environmental impacts and comply with environmental policies, standards and environmental laws.

### 11.7.3 Objectives of Environmental Audit

The major objectives of the environmental auditing are as follows:

**(i) Proper Utilisation of Natural Resources** At national level, the main objective of environmental audit is to see that the natural resources are properly utilised and proper steps have been undertaken to control or to prevent adverse affects of production, development and other activities on the environment.

**(ii) Fulfilling Environmental Responsibilities** At corporate level, environmental audit is done to examine whether the organisation has fulfilled the environmental responsibilities like regulatory requirements, cleaning up pollution that already exists, properly disposing of the hazardous material, disclosing to the investors the amounts and nature of the preventive measures taken by the management, operating in a way that environmental damage does not occur, and promoting a company-wide environmental attitude.

**(iii) Evaluating Environmental Performances** Environmental audit aims at evaluating and reporting key environmental performances measures like, pollution control measures, energy conservation or waste management techniques, etc.

**(iv) Conservation of Scarce Natural Resources** The main objective of an environmental audit at organisational level is to ensure conservation of scarce natural resources and to promote use of clean technologies in industrial production and to minimise generation of pollution and waste.

The other objectives of Environmental Audit are:

(i) **Regulatory Compliance** It helps the management to determine and document compliance status as per the requirement of different regulatory bodies.

(ii) **Improve Performance** It helps to improve environmental performance at operational facilities.

(iii) **Increase Awareness** It increases the overall level of environmental awareness among the employee and other stakeholders.

(iv) **Protect from Risk and Liabilities** It protects the corporation from potential liabilities and risk arising out of any unwanted circumstances.

### 11.7.4 Advantages of Environmental Auditing

Advantages of environmental auditing are:

(i) **Cost Effective Compliance with Environmental Laws and Regulations** The most important benefit of environmental audit is that it ensures cost effective compliance with environmental laws and regulations, industry guidelines and standards, and company's own environmental policies.

(ii) **Efficient Environmental Management System (EMS)** Environmental auditing encourages an organisation to examine its operations in a constructive manner and is the cornerstone of an effective EMS. It helps in assessing performance of the EMS, identifies deficiencies in the system and provides the basis for environmental improvement plans.

(iii) **Meeting Stakeholders' Expectations** Conducting environmental audits will help in reassuring various stakeholders that the company is living up to its environmental principles. It helps in enhancing reputation of the company as a good corporate citizen. It assists good relations with control authorities and also increases confidence with the general public.

(iv) **Minimisation of Risks** Environmental audit can act as effective risk management tool for assessing compliance with environmental legislation, and thereby, assisting your company in avoiding the risk of prosecution and fines are arising from potential environmental breaches. This is particularly true for those involved in hazardous polluting industries.

(v) **Encourages Continual Improvement** By pinpointing both strengths and weaknesses in the environmental management and other operating systems relating to the environment on a regular basis, an environmental audit encourages continual improvement. It is to be noted that environmental audit will cost an organisation both time and money but if approached correctly, the organisation should be able to recover these costs very easily.

(vi) **Compliance with Certification Requirements** Conducting an environmental audit can be important step towards gaining a companywide certifications like ISO 14001

or cradle to grave or product specific certification form organisation like, Energy Star, LEED, the Forest Stewardship Council, Chlorine Free Products Association, etc.

**(vii) Improving Operational Efficiencies** Environmental auditing can highlight areas of inefficiencies in the operations and processes, for examples, where the amount of resources used are out of proportion to the amount of items or services produced and sold. By identifying operational inefficiencies, a company may be able to reduce its cost and or improve its environmental performance. In addition, it also highlights ways of safeguarding the environment.

**(viii) Increases Awareness Among Employees of** Environmental audit demonstrates the company's commitment to environmental protection to its employees. It upgrades the level of information for use in emergency situations like fire etc.

**(ix) Assists Management in Decision-making** Environmental audit provides an environmental database to assist management decisions on plant modifications, designing of new projects, identifying new market and commercial opportunities. It also enables management to set targets and give credit for good environmental performance.

## 11.8 PROPRIETY AUDIT

### 11.8.1 Concept

The term propriety means justness or rightness. When this term is applied in the area of auditing, it signifies the audit of rightness of expenditure incurred or the rightness of optimum result of selecting alternative plan of action.

### 11.8.2 Definition

Propriety audit may be defined as an appraisal of rightfulness of executive actions and plans. In the conduct of propriety audit, the role of an auditor resembles more to advisory function rather than executive function. So, propriety audit refers to the assessment of rightness of plans and policies of management in connection with various financial events or transactions of the business.

According to E L Kohler, "Propriety Audit is an audit in which various actions and decisions are examined to find out whether they agree in public interest and whether they meet the standards of the conduct."

### 11.8.3 Objectives

Propriety audit has ample scope of applicability. The objectives of this type of audit are discussed below:

**(i) Interest of People** To see that the different policies and operations are in the interest of the people.

**(ii) Interest of the Organisation** To see also that transactions of the business are contradictory to the interest of the organisations and the people, at large.

**(iii) Compliance with GAAP** To see whether the transactions of the concern are contradictory to the generally accepted accounting principles.

**(iv) Rationality of the Transaction** To examine whether the transactions of the business are reasonable, rationale, or for the welfare of the people.

**(v) Protection of Assets** To see that through these transactions the assets of the business are properly protected.

**(vi) Protection to Capital** To see that the capital invested are intact through these transactions.

**(vii) Status of Assets** To see whether the assets were willfully destroyed or demolished or discarded or misused.

### 11.8.4 Advantages

Propriety audit has the following advantages:

**(i) Detection of Misuse and Fraud** In propriety audit wastes, misuse of assets and frauds are detected. So, guilty persons can be punished. The loopholes in the internal control systems of the organisation can also be adequately plugged to minimise these in future.

**(ii) Well Judged Decision** If financial considerations or standards of propriety are flouted in any decision, propriety audit brings these to the notice of the authority. So, decision-maker always remains very alert and well-judged decisions result in the organisation.

**(iii) Safeguard the Interest of the Organisation** This audit also checks whether or not all the activities of the organisation have been carried on prudently, profitably and in the best interest of the organisation. If anything is pointed out adversely in the audit report, appropriate corrective action can be taken against it.

**(iv) Protecting Assets** If any asset of the organisation is inadequately protected, propriety audit brings this to light. Accordingly, measures can be taken to protect the asset from loss or damage.

**(v) Preventive Measures** Inefficiently, extravagance, personal interest on any matter, etc. are detected in propriety audit. So, adequate preventive measures can be taken against these.

**(vi) Increase Administrative Efficiency** Propriety audit may cause useful corrections in financial and general administration. For this administrative efficiency of the organisation may increase.

**(vii) Improve Effectiveness of Financial and Cost Audit** Without the consideration of propriety in some important matters, financial audit and cost audit will be of little value. These audits can be really effective when propriety audit in certain areas become part of them.

**(viii) Benefits Shareholders** The shareholders of a company or the proprietors of a business are the maximum beneficiaries from propriety audit, because propriety audits in commercial organisations mainly see their interests.

**(ix) Benefits other Stakeholders** Not only are shareholders or the proprietors, but also all those connected with the business are benefited from propriety audit as this audit keeps an eye on financial discipline in the day to day management of the business, which is also beneficial to the society at large.

**(x) Government Department** Propriety audit is indispensable in government departments and in government or public transitions, because their activities, transactions, expenditure and decisions are supposed to be in public interest.

### Difference between Traditional Audit and Propriety Audit

| Points of Difference | Traditional Audit | Propriety Audit |
|---|---|---|
| Objectives | In traditional audit, all business transactions are checked with the help of vouchers and documents to ascertain whether the financial statements prepared gives a true and fair view of the financial position of the enterprise. | In propriety audit, the matters to be observed are whether the transactions entered into and all the business activities including the decision taken by the management are in conformity with the standards of propriety. |
| Fund utilisation | It is not the purpose of traditional audit to discover wastes and misuse of fund. | Discovery of wastes and misuses of fund is the main purpose of propriety audit. |
| Accepted standards | If an expense is duly approved by the appropriate authority and supported by valid vouchers, it meets the accepted standard of traditional audit. | Mere approval and existence of supporting vouchers against an expense will not satisfy the auditor in propriety audit. The auditor has to verify whether the expense is necessary and the amount incurred is reasonable or not. |
| Function | It is not within the function of traditional audit, to see whether the business is being managed prudently and profitably. | It is the function of the propriety audit to see whether the business is being managed prudently and profitably. |
| Verification of assets | In traditional audit all assets described in the balance sheet are verified in respect of existence, title, custody and value of the assets. | In propriety audit what is particularly required to be seen in the case of assets is whether all the assets are adequately protected or not. |
| Detection of fraud | Detection of fraud and misappropriation of fund is not the primary object of traditional audit. It is a secondary object only. | Detection of fraud or misappropriation of fund is one of the primary objects of propriety audit. |

## 11.9 PERFORMANCE AUDIT

### 11.9.1 Concept

The performance or efficiency audit provides the means of appraising the performance of the enterprise and to diagnose the weaknesses or ills of the enterprise. In other words, efficiency audit makes an appraisal of how efficiently different activities of the business, consisting of both operational and financial activities, have been performed and it prescribes the remedies for shortcomings or inefficiencies. Hence, efficiency audit is also known as 'performance audit'.

### 11.9.2 Definition

Performance audit or Efficiency audit may be defined as that part of cost audit, which determines whether the resources of the business flow into remunerative or paying channels. Thus, efficiency audit is concerned with the diagnosis and review of the organisation's environments, measuring return on investment, cash flow performance, etc. and comparing these measures with standard and determining the management system of control and techniques.

Performance audit can be defined as the appraisal process through which it is to be seen that to what extent the concern is gaining success by comparing the different methods and yardsticks. Through this audit, the efficiency or reaching the objective/target of the concern is examined.

### 11.9.3 Objectives

The objectives of the performance audit or the efficiency audit are:

(i) To examine the standard of managerial operations.

(ii) To examine the standards of accounting principles and methods.

(iii) To examine in details the organisational activities.

(iv) To analyse in details the Profit & Loss Account and to give his comment in a report.

(v) To analyse and determine the ratio of output to sales.

(vi) To see whether the sales, sales promotion and the sales management are commensurate to the standard of the concern.

(vii) To see whether the amount of profit attains its target and to examine whether there is any deviation.

(viii) To examine whether the total output attains its maximum, and also to see the causes of its deviations, if any.

(ix) To see whether the planning of extension of business and factory premises were completed.

(x) To see whether the concern attains the expected quality in regard to its output.

(xi) To see whether the inventory management is effective or not.

(xii) To see that the capital employed are utilised properly.

### 11.9.4 Scope

Performance audit involves an appraisal of the performance or efficiency of an enterprise. Performance audit reviews how efficiently various plans have been formulated and how far the actual performance meets the target as planned. Performance audit analyses the variances of actual expenditure from the budgeted figures. It also checks the results of capital investments and tries to find out how efficiently the capital has been utilised. Performance audit is, therefore, a check of efficiency of the different aspects of an organisation. It helps the management to improve the overall performance of the organisation. The important aspects of an organisation, which a performance auditor evaluates, include the following:

(i) Sales value and sales quantity
(ii) Actual production and total cost of production
(iii) Levels of inventory and its management
(iv) Capital employed and its utilisation
(v) Profitability of the concern
(vi) Solvency and liquidity position of the concern

By comparing the actual figures with the budgeted figures, standards and figures of the past periods, by proper analysis of the data and by inter-firm comparison, performance audit evaluates the organisation's efficiency.

### 11.9.5 Advantages

Performance audit has the following advantages:

(i) **Performance Evaluation** Performance audit gives insight into the quality of performance. It gives us the idea as to whether the goals and objectives of the organisation have been kept in view and whether the plans and budgets have been followed in the operation of the business activities.

(ii) **Efficient Discharge of Duties** Due to the existence of performance audit, all employees of the organisation become aware of efficient discharge of duties, otherwise the performance auditor will detect their inefficiencies. This moral check on employees is of immense value to the organisation.

(iii) **Detection of Limitations** The defects and limitations in plans, budgets and standards setting are also detected in performance audit. On the basis of audit observations, these defects and limitations can be eliminated.

(iv) **Identify Errors** By conducting performance audit, the errors, defects and inconsistencies in different areas of management can be identified. So, proper actions can be taken to remove these defects and inconsistencies.

(v) **Improve Future Performance** The performance auditor gives the management proper advice for the removal of existing defects and inefficiencies and in that way helps the management to improve future performance of their activities.

### 11.9.6 Disadvantages

The performance audit has the following limitations:

(i) **Post-mortem Audit** Performance audit is a post-mortem audit, i.e., examination of the events of what have already been occurred. In reality, this practice does not give better results.

(ii) **Necessity** If the management control system of the organisation is effective, there cannot be any necessity of performance audit.

(iii) **Not Suitable for small Organisation** Conducting performance audit requires substantial cost. So, this type of audit is not suitable for small organisations.

(iv) **Reported after Long Time** In performance audit, errors and defects are highlighted long after it occurred. Such errors or defects may not be in existence when it is reported to the management.

(v) **Creates Unhealthy Atmosphere** Performance audit creates an unhealthy atmosphere in the organisation due to the competition among the employees in achieving the desired performance.

**Differences between Performance Audit and Cost Audit**

| Points of Distinction | Performance Audit | Cost Audit |
|---|---|---|
| Meaning | Performance audit evaluates the performance in various spheres of the organisation like material procurement and usage, manpower utilisation, profitability and productivity, job performance, financial planning and control, etc. | It is verification of correctness of cost accounts and of the adherence to cost accounting plans. |
| Coverage | It covers all important functions of the organisation namely, production function, purchase functions, administration function and selling & distribution function. | Cost audit is mainly concerned with production function of the organisation. |
| Nature | It highlights wastage, inefficiency and non-performance in all the areas of the organisation. | Cost audit mainly highlights wastage and inefficiency in the manufacturing area. |
| Compulsion | Performance audit is not statutorily compulsory. It is conducted as per the requirement of the management. | Cost audit is conducted as per prescribed rules and procedures. It is a statutory requirement in some industries as notified by the Government. |

(Contd.)

| | | |
|---|---|---|
| Relationship | Two important tools of performance audit are standard costing and budgetary control. | Cost audit provides information and data required for fixation of standard and budget. |
| Applicability | Performance audit is applicable in any kind of organisation, namely, manufacturing, trading, financing, etc. | It is applicable only in some specified manufacturing mining, processing and service industries and trading activities. |
| Report | Performance audit is conducted at the behest of management and its report is submitted to the management for their perusal for taking necessary corrective actions. | Since cost audit is conducted as per statute, the copy of cost audit report is required to be furnished to the Central Government by the management along with full information and explanation on every reservation on qualification as made by the cost auditor. |
| Who conducts | Management gets performance audit done by its own staff who is generally the internal auditor. | As per statutory requirement, it is got done by a cost accountant in practice. |

## 11.10 PROFESSIONAL ETHICS

### 11.10.1 Concept

The dictionary meaning of 'ethics' is moral principles that govern a person's behaviour or the conducting of an activity. It is the branch of knowledge that deals with moral principles. Professionals and those working in acknowledged professions exercise specialist knowledge and skill. How the use of this knowledge should be governed when providing a service to the public can be considered a moral issue and is termed as professional ethics. Professional ethics encompass the personal, organisational, and corporate standards of behavior expected by professionals. Every professional has some enforced code of ethics which need to be followed to preserve the integrity of the profession.

### 11.10.2. Definition

The International Federation of Accountants (IFAC), in its guidelines on Professional Ethics for the Accountancy Profession, has stated: "Persons who pursue a vocation in which they offer their knowledge and skills in the service of the affairs of other have responsibilities and obligations to those who rely on their work. An essential pre-requisite for any group of such persons is the acceptance and observance of professional, ethical standards regulating their relationship with clients, employers, employees, fellow members of the group and the public generally."

In India, as a professional in the field of accountancy both the chartered accountant and cost accountant have to follow the provision of the corresponding act. The Chartered Accountants are guided by the Chartered Accountant Act, 1949 and the Cost Accountants are guided by the Cost and Works Accountants Act, 1959. However, the professional ethics of the Chartered Accountant are to be discussed in this chapter.

As professionals, Chartered Accountants are engaged in building trust to a vast variety of users, whether shareholders, government, banks, investors, employee or others, which impose a public interest responsibility on their profession. Like other professionals, Chartered Accountants also have some set of code of ethics. A Chartered Accountant, either in practice or in service, has to abide by these behaviours. They are expected to follow the fundamental principles of professional ethics while performing their jobs.

### 11.10.3 Objectives

The objectives of the accountancy profession are to work to the highest standard of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement. The International Federation of Accountants (IFAC) in its code of ethics for Professional Accountants has stated the following objectives for the profession:

#### A. To Safe the Public Interest

A distinguishing mark of a profession is acceptance of its responsibility to the public. In accountancy profession, public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of professional accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on the accountancy profession. The public interest is defined as the collective well-being of the community of people and institutions the professional accountant serves.

#### B. Credibility

Creditability means the quality of being trusted and believed in the whole of society, there is a need for credibility in information and information system. So a Chartered Accountant should perform his job with creditability.

#### C. Professionalism

There is a need for individuals who can be clearly identified by clients, employers and other interested parties as professional persons in the accountancy field.

#### D. Quality of Services

There is a need for assurance that all services obtained from a professional accountant are carried out to the highest standards of performance.

#### E. Confidence

Users of the services of professional accountants should be able to feel confident that there exists a framework of professional ethics which governs the provision of those services.

### 11.10.4 Fundamental Principles of Professional Ethics

In order to achieve the objectives of the accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles. The fundamental principles are:

(i) **Integrity** A professional accountant should be straightforward and honest in performing professional services.

(ii) **Objectivity** A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

(iii) **Professional Competence** A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice legislation and techniques.

(iv) **Due Professional Care** It does not require ultimate expert, but does extend to every aspect of the audit including the evaluation of audit risk, formulation of audit objective, establishment of audit scope, selection of audit tests and evaluation of test result. It requires an individual to exercise the skill of a level commonly possessed by practitioners of that specialty.

(v) **Confidentiality** A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

(vi) **Professional Behaviour** A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession. The obligation to refrain from the conduct which might bring discredit to the profession requires IFAC member bodies to consider, when developing ethical requirements, the responsibilities of a professional accountant to client, third parties and other members of the accountancy professions, staff, employers and the general public.

(vii) **Technical Standards** A professional accountant should carry out professional services in accordance with the relevant technical and profession standards. Professional accountants have a duty to carry out with care and skill, the instruction of the client or employer in-so-far as they are compatible with the requirements of integrity, objectivity and, in the case of professional accountants in public practice, independence.

### 11.10.5 Professional or Other Misconduct

According to Section 22 of the Chartered Accountants Act, 1949, for the purpose of this Act, the expression 'professional or other misconduct' shall be deemed to include any act or omission

provided in any of the Schedules, but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Disciplinary) under Sub-section (1) of Section 21 to inquire into the conduct of any member of the institute under any other circumstances. A member is liable to disciplinary action under Section 21 of the Chartered Accountant Act, if he is found guilty of any professional or other misconduct.

### A. Professional Misconduct

Professional misconduct has been defined in Part I, II and III of the First Schedule; and Part I and II of the Second Schedule. A member who is engaged in the profession of accountancy whether in practice or in service should conduct/restrict his action in accordance with provisions contained in the respective parts of the schedules. If the member is found guilty of any of the acts or omissions stated in any of the respective parts of the schedule, he/she shall be deemed to be guilty of professional misconduct.

### B. Other Misconduct

Other misconduct has been defined in Part IV of the First Schedule and Part III of the Second Schedule [Newly inserted parts by Chartered Accountants (Amended) Act, 2006]. This provision empowers the Council to inquiry into any misconduct of a member even it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action. For example, a member who is found to have forged the will of a relative would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty.

Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with cause transportation or imprisonment to an offence not of a technical nature committed by the member in his professional capacity [*See Section 8(v) of the Act*].

Some illustrative examples, where a member may be found guilty of 'other misconduct', under the aforesaid provisions rendering himself unfit to be a member are:

(i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.

(ii) Where a chartered accountant makes a material misrepresentation.

(iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.

(iv) Conviction by a competent court of law for any offence under Section 8(v) of the Chartered Accountant Act, 1949.

(v) Misappropriation by office bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.

(vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.

(vii) Where certain assessment records of income tax department belonging to the client of Chartered Accountant were found in the almirah of the bed room of the chartered accountant.

(viii) Where a chartered accountant had adopted coercive methods on a bank for having a loan sanctioned to him.

### 11.10.6 Schedules to the Act

Acts or omission which comprise professional misconduct within the meaning of Section 22 of the Chartered Accountants Act, 1949 are defined in two schedules i.e. the First Schedule and the Second Schedule.

The First Schedule is divided into four parts:

(i) Part I of the First Schedule deals with the misconduct of a member in practice which have the effect generally of compromising his position as an independent person.

(ii) Part II deals with misconduct of members in service.

(iii) Part III deals with the misconduct of members generally.

(iv) Part IV deals with other misconduct

The Second Schedule is divided into three parts:

(i) Part I deals with the misconduct in relation to a member in practice.

(ii) Part II deals with misconduct of members generally.

(iii) Part III deals with other misconduct in relation to members of the institute generally.

### 11.10.7 Selected Sections of the Act

#### A. Penalty for Falsely Claiming to be Member etc.

Section 24 of the Act provides – any person who

(i) not being a member of the Institute

   (a) represents that he is a member of the Institute; or

   (b) uses the designation Chartered Accountant.

(ii) being a member of the Institute, but not having a certificate of practice, represents that he is in practice or practices as a Chartered Accountant, shall be punishable on first conviction with fine which may extend to one thousand rupees, and on any subsequent conviction with imprisonment which may extend to six months or with fine which may extend to five thousand rupees, or with both. In a case under the above provision, the Court of Additional Chief Judicial Magistrate had by its judgment dated 18$^{th}$ July, 1989 found the accused guilty under Section 24 (i) (a) and (b) of the Chartered Accountant Act

and Section 465 of the Indian Penal Code. The Court imposed a fine on the accused and in the event of his failure to pay the fine, sentenced to rigorous imprisonment for three months. (*Case of Prem Batra decided on 18.7.1989 and published in September, 1989 issue of the Institute's journal at page 246*)

**B. Companies not to Engage in Accountancy**

Section 25 provides that:

(i) No company, whether incorporated in India or elsewhere, shall practice as chartered accountants.

(ii) If any company contravenes this provision, then, without prejudice to any other proceedings which may be taken against the company, every director, manager, secretary and any other officer thereof who is knowingly a party to such contravention shall be punishable with fine which may extend on first conviction to one thousand rupees, and on any subsequent conviction to five thousand rupees.

**C. Unqualified Persons not to Sign Documents**

Section 26 provides that:

(i) No person other than a member of the Institute shall sign any document on behalf of a chartered accountant in practice or a firm of such chartered accountants in his or its professional capacity.

(ii) Any person contravenes this provision shall, without prejudice to any other proceedings, which may be taken against him, be punishable on first conviction with a fine not less than five thousand rupees but which may extend to one lakh rupees, and in the event of a second or subsequent conviction with imprisonment for a term which may extend to one year or with fine not less than ten thousand rupees but which may extend to two lakh rupees or with both.

## 11.11 AUDITOR'S INDEPENDENCE

### 11.11.1 Concept

Auditor's independence means ability of the auditor to express opinion on the financial statements without any influence from parties that have an interest in the results published in the financial statements of the entity. It implies that the auditor's judgment on the authenticity of the financial statements is not subordinate to the wishes of the director or other parties, more specifically company managers/directors or to his own self interest. Independence is characterised by integrity and an objective approach to the audit process. The concept requires the auditor to carry out his or her work freely without any pull and pressure.

### 11.11.2 Definition

There are two interlinked perspective of independence of auditors, one, independence of mind and two, independence of appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term 'independence' as follows:

'Independence' is:

(a) Independence of mind - the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and professional skepticism; and

(b) Independence in appearance - the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information including any safeguards applied, would reasonably conclude a firm's or a member of the assurance team's integrity, objectivity or professional skepticism had been compromised"

In all phases of a Chartered Accountants's work he is expected to be independent, but in particular in his work as auditor, independence has a special meaning and significance. Not only the client but also the stakeholders, prospective investors, bankers and government agencies rely upon the accounts of an enterprise when they are audited by a Chartered Accountant. So, a Chartered Accountant is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work such as his training and experience enables him to do so.

### 11.11.3 Advantages of Independent Audit

**(i) Protect the Public Money from Scam** The principal advantage of an independent audit lies in the society being able to get an informed, objective and unbiased opinion on the financial statements of an organisation which is used in making significant economic decisions by interested segments of the society, i.e., shareholders, creditors, bankers, etc.

**(ii) Safeguard the Stakeholders** It is to be noted that only the auditor is in a position to examine the accounts and transactions of an organisation with a view to form an opinion. His report is, therefore, the only real safeguard available to the various parties interested in the financial affairs of the organisation.

### 11.11.4 Real Independence and Perceived Independence

There are two aspects of auditor's independence—independence in fact (real independence) and independence in appearance (perceived independence). Together, both forms are essential to achieve the goals of independence. Real independence refers to independence of mind. It determines how the auditor is going to deal with a particular situation. It enables him to make independent decisions even if he is under some pressure from company directors. Independence in appearance, on the other hand, implies that the auditor should act in a manner that other people consider him independent.

It is essential that the auditor not only acts independently, but appears independent too. If an auditor is in fact independent, but one or two factors suggest otherwise, people will be led to conclude that financial statements do not reflect a true and fair view. For example, if the auditor renders any consultancy service to the client apart from conducting statutory audit, his independence is likely to be suspected.

### 11.11.5 Types of Independence

The statutory auditor should have three types of independence. These are as follows:

(i) **Programming Independence** It implies that the auditor should be at liberty to select the most appropriate strategy while conducting an audit. It is he who will decide his audit plan without being influenced by wish or direction of another person.

(ii) **Investigative Independence** It indicates that the auditor should be able to implement his audit strategy in whatever manner he considers necessary. He should have unlimited access to all company information. He must have right to get answers to all queries he makes regarding company's business and accounting treatment.

(iii) **Reporting Independence** This independence implies that auditors should have ability to disclose any information relevant to the users for taking decisions.

### 11.11.6 Importance of Auditor's Independence

(i) **Protect the Public from Scam** The stakeholders of the company take various economic decisions based on the audited financial statements, but since 2000, a number of scams and accounting scandals in many globally reputed companies like Enron, World.com, etc. could not be brought to light by auditors. In India, the recent accounting scam in Satyam Company is a glaring example of audit failure. So, the perception of the people about the integrity of audit profession is now gradually changing. It is being thought that there is a wide-spread collusion between auditors and management which results in drainage of public money.

(ii) **Safeguard the Stakeholders** In this background, the question of auditor's independence has assumed a special significance. It is now being considered as the cornerstone of the auditing profession. The auditor should carry out his work freely and in an objective manner. He should express an unbiased opinion on the financial statements so that stakeholders can rely on his opinion and can safeguard their interest. This will lead to economic development of the country by bringing prosperity to business.

### 11.11.7 Important Aspects of Auditor's Independence

Auditor's independence is an important factor in establishing the creditability of the audit opinion Auditor's independence refers to the independence of the auditor from parties, other than shareholders, that have an interest in the financial statements of an entity and, in particular, independence of the auditor from the management of the entity.

There are two aspects to independence—independence in fact and independence in appearance. Independence in fact refers to the actual independence of the auditor. It is concerned with the state of mind of the auditor and how the auditor acts in a specific situation. It is difficult and, in many cases, not possible, to determine whether an auditor has acted independently, because it involves knowing what was going on in the mind of the auditor at the time of audit.

The other aspect of independence is independence in appearance. This is how other people might view the independence of the auditor. It is necessary for auditors to not only act independently but also be seen to be independent, because independence in appearance reduces the opportunity for an auditor to act otherwise than independently.

Auditor's independence as it relates to independence in appearance may be addressed in statutory law, professional standards and audit firm policy.

For example, statutes, standards and/or individual audit firm policy may address independence by:

**(i) Prohibiting Holding Shares** Prohibiting owners of accounting firms (e.g., proprietors and partners) and their staff from holding shares in, lending to or otherwise having a beneficial interest, either directly or indirectly, in audit clients.

**(ii) Prohibiting Receiving any Benefits** Prohibiting owners and their staff from receiving any benefits from client organisations, other than through the receiving of audit fees. This includes a prohibition of owners and their staff from:

- (a) Borrowing money from the audit client,
- (b) Accepting commissions for the new business referred by the audit firm to the audit client, and
- (c) Accepting discounts given to the audit staff members, normally available only to the client's staff.

**(iii) Prohibiting Holding any Office of Client** Prohibiting owners and their staff members from holding any office, including the office of director, in client organisations.

**(iv) Independent Statement** Preparations and maintenance of a list of clients and associated companies that is made available to all owners and staff of the audit firm, and annual signing by all owners and staff of an independent statement, stating that they are familiar with the firm's independence policy, they hold no prohibitive investments and they hold no prohibitive relationships.

**(v) Prohibiting of Consulting Work** Prohibiting the undertaking of consulting work (such as taxation and corporate advising work) for existing audit clients.

### 11.11.8 Legal Measures for Ensuring Auditor's Independence

#### The Companies Act, 2013

The Companies Act, 2013 has enacted some specific provision for ensuring auditor's independence. These are as follows:

(i) The provisions disqualifying certain types of persons from undertaking audit in limited companies. [Sec. 141 (3)]

(ii) Provisions requiring resolution of members for appointing auditors in the annual general meeting. [Sec. 139(1)]

(iii) Provisions on appointment, re-appointment and removal of auditors, which aim at ensuring sufficient independence of auditor to carry out the audit in the larger interest of shareholders and others. [Sec. 139(1) & 140(4)]

(iv) Provisions relating to ceiling on the number of audits that can be undertaken by a Chartered Accountant. [Sec. 141(3)]

(v) Power to qualify his report is yet another weapon in the armoury of auditor to protect his independence. [Sec. 143(3)]

(vi) Establishment of Audit Committee. [Sec. 177]

(vii) Appointment of Statutory Auditor in the government companies on the recommendation of the CAG. [Sec. 139(7)]

(viii) Appointment of Statutory Auditor in the public sector banks under the supervision of Reserve Bank of India. [Sec. 30(1) of Banking Regulation Act, 1949]

(ix) Establishment of Peer Review Board by the Institute of Chartered Accountants of India to evaluate the performance of audit firms.

(x) Statutory auditors are not allowed to undertake non-audit services. [Sec. 144]

(xi) As per Clause 139(2) of the companies Act, 2013, in case of listed companies, an individual can be appointed as auditor for only one term of five consecutive years. For an audit firm, the tenure of service is ten consecutive years.

(xii) Companies Act, 2013 also provides for constitution of National Financial Reporting Authority which will supervise the quality of audit service. [Sec. 132]

### The Chartered Accountants Act, 1949

The Chartered Accountants Act, 1949 has also enacted various provisions for ensuring auditor's independence. For example, a chartered accountant will be held guilty of professional misconduct:

(i) If he charges or offers to charge, accepts or offers to accept in respect of any professional employment, fees which are contingent upon the findings or results of such employment, except in cases which are permitted under any regulations made under this Act. [Clause 10 of Part I of First Schedule]

(ii) If he expresses his opinion about the financial statement of an enterprise in which he has a substantial interest unless he discloses the interest in his report. [Clause (4) of Part-l of Second Schedule]

(iii) If he advertises for soliciting work or advertise in a manner which could be interpreted as soliciting or offering to undertake professional work. [Clause (4) of Part-l of First Schedule]

## 11.12 AUDIT UNDER COMPUTERISED INFORMATION SYSTEM (CIS) ENVIRONMENT

### 11.12.1 Concept

Now-a-days, the corporate world is getting more and more inclined towards the use of information technology in their daily operations. This has changed the way in which the organisations carry out their operations and various business processes. Auditing in Computer Information System (CIS) environment discusses the procedure to be followed when an audit is conducted in a CIS environment. Auditing in a CIS environment even though has not changed the fundamental nature of auditing, it has definitely caused substantial changes in the method of evidence collection and evaluation. This also requires auditors to have knowledge about computer environment (Hardware, software, etc.) and keep pace with rapidly changing technology, even to the extent of using sophisticated audit software.

**Difference between Auditing of Manual Accounts and Computerised Accounts**

| Point of Difference | Conventional Auditing System | Computer Based Auditing System |
|---|---|---|
| Complexity | Conventional Auditing System is simple; therefore, it can be understood by the auditor quickly. | Computer Based Auditing System is complex. So it requires technical expertise and lot of time to understand by the auditor. |
| Audit trail | The audit trial includes source document, journal entries, ledgers, trial balance and other records. Audit trial can be done satisfactorily. | The audit trial consists of magnetic tapes, punch cards, discs, printouts, etc. There is a lack of audit trail in this system. |
| Internal control system | Internal control system is based on segregation of duties essentially. | Internal control system is based on separation of knowledge. |
| Audit planning | Scheduling of audit planning is not very tight. | Involves tighter scheduling of audit planning because the client has to make arrangements to provide auditor access to computer system and make available various files. |
| Consequences of error | Errors are not stochastic and not repeated in nature. | Consequences of error in a computer system are a serious matter as errors in a computer system are deterministic i.e. an erroneous programme will; always execute data incorrectly. |
| Correction of Errors | Errors can be corrected on the basis of feedback given by the auditor. | Extensive redesigning and reprogramming may be required to correct them. |
| Skill & Competence | An auditor can perform his work manually with basic knowledge in computer. | An auditor should have sufficient knowledge of the computer information system to plan, direct, supervise, controls and review the work performed. |
| Evidence Collection | The auditor has to go through books of accounts and vouchers to collect evidences. The evidences are mostly in paper form. | Auditors have to run through computer themselves if they want to collect necessary evidences. Most of audit evidences are in electronic form. |

### 11.12.2 Scope of Audit in a CIS Environment

Impact of computerisation on audit approach needs consideration of the following factors:

**(i) High Speed** In a CIS environment, information can be generated very quickly. Even complex reports in specific report format can be generated for audit purposes without much loss of time. This cuts down the time, enabling the auditor to extend their analytical review for under coverage with high speed of operation, the auditor can expand their substantive procedures for collection of more evidence in support of their judgment.

**(ii) Low Clerical Error** Computerised operation being a systematic and sequential programmed course of action the changes of commission of error is considerably reduced. Clerical error is highly minimised.

**(iii) Concentration of Duties** In a manual environment, the auditor needs to deploy separate individuals for carrying out the verification process. However, in a CIS environment, the traditional approach does not apply in many cases, as computer programs perform more than one set of activities at a time, thereby concentrating the duties of several personnel involved in the work.

**(iv) Application Systems Development Control** Systems development control should be designed to provide reasonable assurance that they are developed in an authorised and efficient manner to establish control over:

(a) Testing, conversion, implementation, and documentation of new revised system.
(b) Changes to the application system.
(c) Access to the system documentation.
(d) Acquisition of the application system from third parties.

**(v) Systems Software Control** Systems controls are designed to provide software reasonable assurance that system software is acquired or developed in an authorised and efficient manner including:

(a) Authorisation, approval testing, implementation and documentation of new system software systems software modifications.
(b) Putting restriction of access to system software and documentation to the authorised personnel.

**(vi) Disappearance of Manual Reasonableness** The shift from traditional manual information processing environment to computerised information system environment needs a detailed analysis of the physical system for transformation into a logical platform. In creating such logical models many stages required under manual operations are either deleted or managed to create a focused computer system. In a such creative effort, the manual reasonableness may be missing.

**(vii) Impact of Poor System** System analysis and designs when fall short of expected standard of performance, a computerised information system environment may do more harm to integrated business operation than good. Thus, care has to be taken in adopting manual operations, switch-over to computerised operations for ensuring performance quality standards.

**(viii) Exception Reporting** This is a part of management information system. Exception reporting is a departure from straight reporting of all variables. Here, the value of a variable is only reported, if it lies outside some pre-determined normal range. This form of reporting and analysis is familiar to the accountant. The main strength of exception reporting lies in its recognition that to be effective information must be selectivity provided.

**(ix) Man–machine Interface/Human–Computer Interaction** It is required to determine what information was necessary to achieve through a careful analysis of the job or task for which the user needed the information, Human-computer interaction is a discipline concerned with the design, evaluation and implementation of interactive computing systems for human use and with the study of the major phenomena, surrounding them. The approach is user centered and integrates knowledge from a wide range of disciplines.

### 11.12.3 Audit Approach in a CIS Environment

Based on the knowledge and expertise of auditors in handling computerised data, the audit approach in a CIS environment could be either:

- A Black-box approach, i.e., Auditing around the computer, or
- A White-box approach, i.e., Auditing through the computer.

#### A. The Black-Box Approach

The auditor treats the computer as a black box, i.e., concentrates on input and output and ignores the data processing. He assumes, if inputs and outputs are correct, processing would be accurate. For example, the auditor might first examine the time cards for hours spent by the workers and organisational records specifying the rate for payment of workers (input), then trace these to wage sheet (output) and compare the two. This comparison can be done manually or with the help of computer. The auditor is, therefore, relying on the controls in user department.

In testing, say, Payroll Application, the auditor might first examine selected time cards for hours worked and employee earning cards for rates and then trace these to the payroll summary output and finally compare hours, rates and extensions. The comparison of inputs and outputs may be done manually with the assistance of the computer.

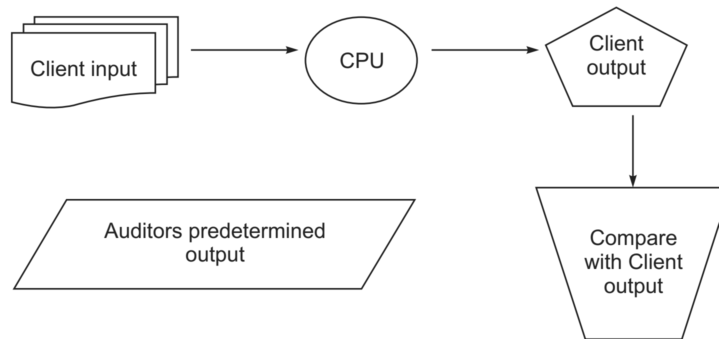


**Fig. 11.3** Auditing Around the Computer

***Advantages***

The computer assisted approach has the advantage of permitting the auditor to make more comparisons than would be possible, if done manually. Auditing around the computer has the advantage of ease of comprehension as the tracing of documents to output does not require any in-depth study of application program.

(i) Audit cost is low
(ii) Requires limited computer knowledge

***Disadvantages***

A major disadvantage, however, is that the auditor not having directly tested the control, cannot make assertions about the underlying process. Moreover, in some of the more complex computer systems, intermediate printout may not be available for making the needed comparisons.

(i) May be expensive as printing of lot of data is required
(ii) Time consuming
(iii) It ignores the huge potential of computers to help the auditor

***Suitability***

This approach is suitable when

(i) the application controls are difficult to comprehend. The auditor can test the computer processes by feeding hypothetical data in the computer for which manual solution is available. Comparison of such a solution can be made with computer generated output and if no material discrepancies are noted, the auditor can use this approach.
(ii) audit trail is available.

**B. The White-Box Approach**

When the use of computer is made by the auditor to carry out compliance and substantive procedure, it is called auditing 'through' the computer or the White Box Approach. He focuses

upon all phases of CIS activities, viz, input, processing and output. The auditor reviews and tests general and application controls and determines their effectiveness and then determines the nature, timing and extent of substantive procedure. The processes and controls surrounding the subject are not only subject to audit but also the processing controls operating over this process are investigated. In order to help the auditor to gain access to these processes, computer audit software may be used.

For example, to vouch payment of wages and salaries, the auditor would use various general and application controls such as record counts, limit tests and check digits, hardware controls, access controls, etc.

The process of auditing is not a straight forward flow of work from start to finish to be completed by satisfying oneself against a standard checklist or a list of questions. It involves exposure, experiences and application of knowledge and expertise to differing circumstances. No two information system can be the same. From the view point of analysis computerised information of system, auditors need not only have adequacy on knowledge regarding information requirement and computer data security, they must also get exposed to system and as post implementation.

***Advantages***

(i) Reduces cost as print-outs are not required
(ii) Helps to reduce audit hours
(iii) Online transactions can be easily recorded

***Disadvantages***

This approach requires that the auditor should have sufficient knowledge of computers, its programmes, process and controls.

***Suitability***

Auditing through the computer may be used in many situations. Some examples are given below:

(i) The application system processes large volume of input and produces large volumes of output, e.g., cash sales in a big departmental store.
(ii) Significant parts of the internal control system are embodied in computer batch transactions for individual tellers to provide control totals for reconciliation at the end of day's processing.
(iii) To make processing more efficient, e.g., EDP system may be used to scan accounts receivable balances for amounts exceeding the credit limit and even for confirming receivable accounts random sampling tables might be used to select sample.
(iv) To facilitate analysis, e.g., the auditor may summarise inventory turnover statistics to determine slow moving inventory items with the help of software.

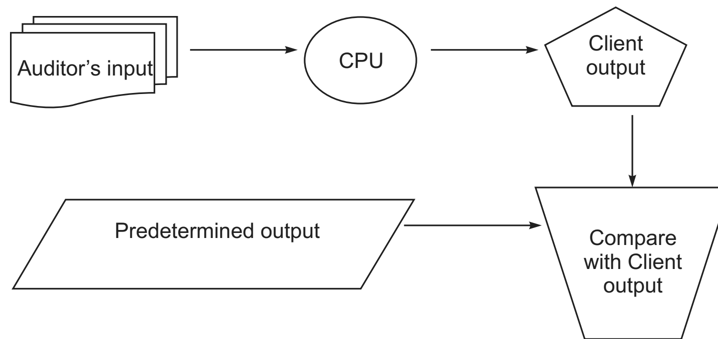


**Fig. 11.4** Auditing Through the Computer

### 11.12.4 Effects of Computers on Auditing

The objective of auditing do not undergo a sea change in a CIS environment. Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to collect and evaluate evidence. These aspects are discussed below:

#### A. Changes to Evidence Collection

Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like,

(i) accurate and complete the operations of a disk drive may require a set of hardware controls not required in the manual system,

(ii) system development control includes procedures for testing programs that again are not necessary in manual control.

The auditors have to face the following challanges in *evidence collection* in a CIS environment:

**(i) Rapid Changes in Technology** Since hardware and software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focused a cryptographic control to project the privacy of data.

**(ii) Communication Network** Unless auditor's keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

**(iii) Development of Control Technology** The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls.

**(iv) Run through Computer System** In a CIS environment, even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves, if they are to collect the necessary evidence. Though generalised audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection.

**B. Changes to Evidence Evaluation**

With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system. Auditors need to understand:

(i) Whether a control is functioning reliably or multi-functioning,

(ii) Traceability of control strength and weakness through the system. In a shared data environment, a single input transaction may update multiple data item used by diverse physically disparate user, which may be difficult to understand.

The auditors have to face the following challanges in *evaluation of evidences* in a CIS environment:

**(i) Errors are Deterministic** Consequences of errors in a computer system are serious matters as errors in computer an system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly.

**(ii) Errors Generated at High Speed** Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high.

**(iii) Redesign and Reprogramming** Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed, implemented and operated upon.

**(iv) Required Control to be Sufficient** The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

### 11.12.5 Computer Assisted Audit Techniques (CAATs)

Computer Assisted Audit Techniques (CAATs) are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance, contained in an entity's information systems. The overall objectives and scope of an audit do not change when an audit is conducted in a Computer Information Systems (CIS) environment. The application of auditing procedures however, the auditor is to consider techniques known as Computer Assisted Techniques (CAATs) that use the computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures.

### A. Reason for Using CAATs

The use of CAATs may be required because

(i) the auditor may not be able to examine documentary evidence because of the absence of input documents (e.g., order entry in online systems) or the generation or accounting transactions by computer program (e.g., automatic calculation of discounts).

(ii) the auditor will not be able to follow transactions through computerised accounting system because of lack of visible audit trail.

(iii) the lack of visible output may necessitate access to data retained on files readable only by the computer.

### B. Advantages of CAATs

(i) CAATs allow the auditor to give access to data without dependence on the client, test the reliability of audit software and perform audit tests more efficiently.

(ii) CAATs may be used in performing audit procedures such as–

(a) Test of details of transactions and balances, for examples, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records.

(b) Analytical procedures, for example, identify inconsistencies or significant fluctuations.

(c) Sampling programs to extract data for audit testing.

(d) Re-performing calculations performed by the entity's accounting systems.

### C. Uses of CAATs

CAATs may be used in performing various auditing procedures, including the following:

(i) Tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records.

(ii) Analytical procedures, for example, identifying inconsistencies or significant functions.

(iii) Tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management.

(iv) Sampling programs to extract data for audit testing.

(v) Tests of application controls, for example, testing the functioning of a programmed control and.

(vi) Re-performing calculations performed by the entity's accounting systems.

### D. Some Techniques of CAAT

**(i) Test Data Approach**

(a) Auditor prepares transaction data (test data, also called test pack) and processes it on the client's processing system under his control.

(b) If results of processing match with the pre-determined output, this indicates that all the applications and general controls are functioning properly.
(c) Test data should test each control on which he wishes to rely.
(d) *Advantages:* Reliable, easy to use and long-term economies.
(e) *Disadvantages:* Additional work for the auditor, difficulty in designing test data and high initial cost.

**(ii) Integrated Test Data Approach**

(a) The auditor creates fictitious entries within the client's actual data.
(b) Hypothetical data for fictitious transactions are, thus, integrated with actual client data and processed.
(c) Subsequently, it is removed by reversing journal entries or through programme commands and then financial reports are compiled.
(d) *Advantages:* Provides assurance that the program being tested by the auditor, have actually been used by the client, long-term economies and can be precisely targeted for specific procedures within the program.
(e) *Disadvantages:* Difficult to ensure that fictitious transactions do not impact actual results, errors may be detected but not well laid frauds difficult to detect and high initial cost.

**(iii) Generalised Audit Software (GAS)**

(a) Audit programms are designed by computer manufacturers, software professionals and large firm of auditors.
(b) The functions that can be performed with GAS include:
- Examination and review of records based on auditor's criteria
- Selecting and printing audit samples
- Testing calculations and making comparisons
- Comparing data on separate files
- Summarising data and performing analysis
- Comparing audit data with client's records

(c) *Advantages:* Assist auditor to carry out compliance and substantive procedures, examines each transaction and reliability.
(d) *Disadvantages:* limited by the availability of client's data, auditor's ingenuity and strength of client's internal control system.

## 11.13 STANDARDS ON AUDITING

### 11.13.1 Concept

The global trade and commerce and the capital market has grown extensively during the last decade. Key aspects of the current business environment include a globalised, highly compet-

itive, expanding economy; explosive growth in the development and use of technology; dramatic increases in new economy service and technology based businesses with predominantly intangible assets; unparalleled expansion in the number of public entities; large increases in the number of individuals who directly or indirectly own equity securities; and unprecedented growth in the market value of those securities. Keeping in mind the effect of changing environment, the professional accountants have adhered to standards and procedures laid down by the professional accountancy bodies.

In simples possible terms, auditing standards represent a modification of the best practice of the profession, which already exists. Auditing standards helps members in proper and optimum discharge of their profession duties. Auditing standards also promote uniformity in practice as also responsibility.

In India, the Institute of Chartered Accountants of India (ICAI) issues the auditing procedures/practices and these are called Standards on Auditing (SA), previously known as Auditing and Assurance Standards (AAS).

### 11.13.2 Importance of Standards on Auditing

The SA refers to general guidelines given by the professional bodies of accountants for conducting audit. They indicate principles and techniques of auditing to be followed by the auditors while conducting audit in a different audit environment. On the basis of the collective deliberations and views, the professional bodies prescribe principles and techniques of auditing. The aim of prescribing these guidelines is to ensure sound and effective auditing practices. The importance of the SA can be outlined in the following way:

(i) **Codification of Auditing Practices** These professional pronouncements attempt to codify the auditing practices expected to be applied while conducting an audit.

(ii) **Ensure Effective Auditing Practices** These professional principles and techniques of auditing are generally accepted as standards. The objective of prescribing these guidelines is to ensure sound and effective auditing practices.

(iii) **Guidance to the Auditors** These standards refer to general guidelines given by the professional bodies of accountants for conducting audit. They indicate the principles and techniques of auditing to be followed by the auditors while conducting an audit.

(iv) **Uniform Presentation of Accounts** Auditing is not a very exact science. To some extent, it is the subject of interpretation. The presence of different concepts, conventions, customs, traditions and practices created confusion and checked free fair and smooth flow of auditing activities. It necessitated uniformity in the concepts, conventions and practices.

(v) **Prevention of Accounting Scandals** Ambiguity, confusion and inexactness in the meaning and interpretation of auditing terminology generate accounting scandals leading to the failure of the business. As such, standardisation of auditing terminology is necessary for preventing misuse of auditing terminology.

### 11.13.3 International Auditing and Assurance Standards Board (IAASB)

The International Auditing and Assurance Standards Board (IAASB) is an independent standard-setting body that serves the public interest by setting high-quality international standards for auditing, quality control, review, other assurance, and related services, and by facilitating the convergence of international and national standards. In doing so, the IAASB enhances the quality and uniformity of practice throughout the world and strengthens public confidence in the global auditing and assurance profession.

The International Federation of Accountants (IFAC) came into existence in 1977 and constituted International Auditing Practices Committee (IAPC) to formulate International Auditing Guidelines. These guidelines were later on converted into International Standards on Auditing (ISA). Considering the developments in the field of auditing at international level, the need for issuing Standards and Guidance Notes in tandem with international standards but conforming to national laws, customs, usages and business environments was felt. With this objective, our Institute constituted the Auditing Practices Committee (IAPC) on September 17, 1982, to spearhead the new framework of Statements on Standard Auditing Practices (SAPs) and Guidance Notes (GNs) *inter alia* to replace various chapters of the old omnibus Statement on Auditing Practices issued in 1964.

### 11.13.4 Auditing and Assurance Standards Board

In July, 2002, the Auditing Practices Committee has been converted into an Auditing and Assurance Standards Board (AASB) by the Council of the Institute of Chartered Accountants of India (ICAI), to be in line with the international trend. A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Boards, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics.

The main function of the AASB are:

(i) It review the existing auditing practices in India and to develop Statements on Standards on Auditing (SAs) so that these may be issued by the Council of the Institute. While formulating the SAs, the AASB takes into consideration the International Standards on Auditing (ISAs) issued by the International Auditing Practices Committee (IAPC), applicable laws, customs, usages and business environment in India. The SAs are issued under the authority of the Council of the Institute.

(ii) The AASB also issued Guidance Notes on the issued arising from the SAs wherever necessary.

(iii) The AASB has also been entrusted with the responsibility to review the SAs at periodical intervals.

(iv) It formulates General Clarifications, where necessary, on issues arising from standard.

(v) AASB also formulates and issue Technical Guides and Practice Manuals.

### 11.13.5 Standards on Auditing (SAs) issued by AASB

The SAs apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion. The SAs may also have application, as appropriate, to other related functions of auditors. Any limitation on the applicability of a specific SA is made clear in the introductory paragraph of the SA.

#### A. Procedure for Issuing SAs

Broadly, the following procedure is adopted for the formulation of SAs: following procedure is adopted for the formulation of SAs:

(i) The AASB determines the broad areas in which the SAs need to be formulated and the priority in regard to the selection thereof.

(ii) In the preparation of SAs, the AASB is assisted by Study Groups constituted to consider specific subjects. In the formation of Study Groups, provision is made for participation of a cross-section of members of the Institute.

(iii) On the basis of the work of the Study Groups, an exposure draft of the proposed Sais prepared by the Committee and issued for comments by members of the Institute.

(iv) After taking into consideration the comments received, the draft of the proposed SA is finalised by the AASB and submitted to the Council of the Institute.

(v) The Council of the Institute considers the final draft of the proposed SA, and, if necessary, modifies the same in consultation with the AASB. The SA is then issued under the authority of the Council.

#### B. Compliance with the SAs

While discharging their attest function, it is the duty of the members of the Institute to ensure that the SAs are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with the SAs, his report should draw attention to the material departures there from. Auditors are expected to follow SAs in the audits commencing on or after the date specified in the Standards.

#### C. Linkage between SAs and Disciplinary Proceedings

The SAs (as well as other statements on auditing) represent the generally accepted procedure(s) of audit. As such, a member who does not perform his audit in accordance with these statements and fails to disclose the material departures therefore, becomes liable to the disciplinary proceedings of the Institute under Clause (9) of Part I of the Second Schedule of the Chartered Accountants Act, 1949 (as amended by the Chartered Accountants (Amendment) Act, 2006), which specifies that a member of the Institute engaged into practice shall be guilty of professional misconduct if he "fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances".

### D. Engagement Standards and Quality Control Standards

As per the Preface to Standards on Quality Control Auditing Review, other Assurance and Related Services w.e.f. April 1, 2008, the nomenclature of AASs under the authority of the Council are collectively known as the Engagement Standards and Quality Control Standards which include the following:

(i) Standards on Auditing (SAs), to be applied of historical financial information.

(ii) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.

(iii) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, dealing with subject matters other than historical financial information.

(iv) Standards on Related Services (SRCs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

(v) Standards on Quality Control which contains extensive requirements in relation to establishment and maintenance of a system of quality control in the audit firms as well as even for sole practitioners.

## 11.13.6 Standards on Auditing in India (Quality Control and Engagement Standards)

The Standards on Auditing (Quality Control and Engagement Standards) issued by the Council of the ICAI are as follows.

**Standards on Auditing in India**

| S.No. | No. of Standard | Title of the Standard | Effective Date |
|---|---|---|---|
| 1 | SQC-1 | Quality control for firms that perform audits and review of historical financial information, and other assurance and related services engagements | April 1, 2009 |
| 2 | SA-200 | Overall objectives of the independent auditor and the conduct of an audit in accordance with standards on auditing | April 1, 2010 |
| 3 | SA-210 | Agreeing the terms of audit engagements | April 1, 2010 |
| 4 | SA-220 | Quality control for an audit of financial statements | April 1, 2010 |
| 5 | SA-230 | Audit documentation | April 1, 2009 |
| 6 | SA-240 | The auditor's responsibilities relating to fraud in an audit of financial statements | April 1, 2009 |

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|---|---|---|---|
| 7 | SA-250 | Consideration of laws and regulations in an audit of financial statements | April 1, 2009 |
| 8 | SA-260 | Communication with those charged with governance | April 1, 2009 |
| 9 | SA-265 | Communicating deficiencies in internal control to those charged with governance and management | April 1, 2010 |
| 10 | SA-299 | Responsibility of joint auditors | April 1, 1996 |
| 11 | SA-300 | Planning an audit of financial statements | April 1, 2008 |
| 12 | SA-315 | Identifying and assessing the risks of material misstatement through understanding the entity and its environment | April 1, 2008 |
| 13 | SA-320 | Materiality in planning and performing an audit | April 1, 2010 |
| 14 | SA-330 | The auditor's responses to assessed risks | April 1, 2008 |
| 15 | SA-402 | Audit considerations relating to an entity using a Service organisation | April 1, 2010 |
| 16 | SA-450 | Evaluation of misstatements identified during the audits | April 1, 2010 |
| 17 | SA-500 | Audit evidence | April 1, 2009 |
| 18 | SA-501 | Audit evidence—Specific considerations for selected items | April 1, 2010 |
| 19 | SA-505 | External confirmations | April 1, 2010 |
| 20 | SA-510 | Initial audit engagements—Opening balances | April 1, 2010 |
| 21 | SA-520 | Analytical procedures | April 1, 2010 |
| 22 | SA-530 | Audit sampling | April 1, 2009 |
| 23 | SA-540 | Auditing accounting estimates, including fair value accounting estimates, and related disclosures | April 1, 2009 |
| 24 | SA-550 | Related parties | April 1, 2010 |
| 25 | SA-560 | Subsequent events | April 1, 2009 |
| 26 | SA-570 | Going concern | April 1, 2009 |
| 27 | SA-580 | Written representations | April 1, 2009 |
| 28 | SA-600 | Using the work of another auditor | April 1, 2002 |
| 29 | SA-610 | Using the work of internal auditors | April 1, 2010 |
| 30 | SA-620 | Using the work of an auditor's expert | April 1, 2010 |

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| | | | |
|---|---|---|---|
| 31 | SA-700 | Forming an opinion and reporting on financial statements | April 1, 2011 |
| 32 | SA-705 | Modifications to the opinion in the independent auditor's report | April 1, 2011 |
| 33 | SA-706 | Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report | April 1, 2011 |
| 34 | SA-710 | Comparative information—Corresponding figures and comparative financial statements | April 1, 2011 |
| 35 | SA-720 | The Auditor's responsibility in relation to other information in documents containing audited financial statements | April 1, 2010 |
| 36 | SA-800 | Special considerations—audits of financial statements prepared in accordance with special purpose framework | April 1, 2011 |
| 37 | SA-805 | Special considerations—audits of single purpose financial statements and specific elements, accounts or items of a financial statement | April 1, 2011 |
| 38 | SA-810 | Engagements to report on summary financial statements | April 1, 2011 |
| 39 | SRE-2400 | Engagements to review financial statements | April 1, 2010 |
| 40 | SRE-2410 | Review of interim financial information performed by the independent auditor of the entity | April 1, 2010 |
| 41 | SAE-3400 | The examination of prospective financial information | April 1, 2007 |
| 42 | SAE-3402 | Assurance reports on controls at a service organisation | April 1, 2011 |
| 43 | SRS-4400 | Engagements to perform agreed upon procedures regarding financial information | April 1, 2004 |
| 44 | SRS-4410 | Engagements to compile financial information | April 1, 2004 |

## SUMMARY

- Cost audit is an independent examination of cost and other related information in respect of a product or group of products of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.
- Cost audit helps an organisation by increasing productivity, in decision making, setting of standard, arresting corporate sickness, creation of employment opportunities, etc.
- Section 148 of the Companies Act, 2013, deals with the issues of maintenance of cost records and auditing of the cost records by the companies. Through this Section 148, Central Government has made an order for maintaining of cost records and audit of cost records mandatory for specified class of companies.

- Management audit is the unique process appraising the performance of directors, managers or in the other words, appraising the performance of the management.
- Management audit helps management in framing basic policies for the organisation and to define objectives, in preparing a viable and achievable plan for the organisation, in setting up an organisational framework to implement the plans and assists in designing systems and procedures for smooth operations of the organisation.
- Tax audit is an examination of financial records to assess correctness of calculation of taxable profit, to ensure compliance with provisions of the Income Tax Act and also ensure fulfillment of conditions for claiming deductions under Income Tax Act.
- Section 44AB of the Income Tax Act, 1961 gives the provisions relating to the class of taxpayers who are required to get their accounts audited from a chartered accountant.
- Systems audit is the process of collecting and evaluating evidence to determine whether a computer system safeguard assets, maintains data integrity, allows organisational goals to be achieved effectively, and uses resources efficiently.
- Social auditing is a process that allows any organisation to assess its social impact and ethical performance vis-à-vis its stated vision, mission and goals. It helps the organisation to set up measurement criteria for its social impact, account for its social performance, report on that performance and draw up action plans to improve that performance.
- Environmental audit may be defined as a means of management which allows exhaustive, documented, periodical and objective evaluation of the way in which management and equipments of an entity manage and control their environmental impacts and comply with environmental policies, standards and environmental laws.
- Propriety audit is an appraisal of rightfulness of executive actions and plans. In the conduct of propriety audit, the role of cost auditor is more resemble to advisory function rather than executive function. So propriety audit refers to the assessment of rightness of plans and policies of management in connection with various financial events or transactions of the business.
- Performance audit or efficiency audit may be defined as the appraisal process through which it is to be seen that to what extent the concern is gaining success by comparing the different methods and yardsticks. Through this audit, the efficiency or reaching the objective/target of the concern is examined.
- The International Federation of Accountants (IFAC), in its guidelines on Professional Ethics for the Accountancy Profession, has stated: "Persons who pursue a vocation in which they offer their knowledge and skills in the service of the affairs of other have responsibilities and obligations to those who rely on their work. An essential pre-requisite for any group of such persons is the acceptance and observance of professional, ethical standards regulating their relationship with clients, employers, employees, fellow members of the group and the public generally."
- Auditor's independence means ability of the auditor to express opinion on the financial statements without any influence form parties that have an interest in the results published in the financial statements of the entity.

- Auditing in Computer Information System (CIS) Environment discusses the procedure to be followed when an audit is conducted in a CIS environment. Auditing in a CIS environment even though has not changed the fundamental nature of auditing; it has definitely caused substantial changes in the method of evidence collection and evaluation.
- Computer Assisted Audit Techniques (CAATs) are computer programmes and data that the auditor uses as part of the audit procedures to process data of audit significance, contained in an entity's information systems.
- The Standards on Auditing (SAs) refers to general guidelines given by the professional bodies of accountants for conducting audit. They indicate principles and techniques of auditing to be followed by the auditors while conducting audit in a different audit environment.
- In India, The Institute of Chartered Accountants of India (ICAI) issues the auditing procedures/practices and these are called Standards on Auditing (SA), previously known as Auditing and Assurance Standards (AAS).

## EXERCISE

### A. Medium Answer Type Questions (4–6 marks)

1. Is audit of cost accounts necessary? [*C.U. B.Com(H), 1994*]
2. What do you mean by Social Audit? [*C.U. B.Com(H), 1997*]
3. What is Tax Audit? [*C.U. B.Com(H), 2002, 2005*]
4. What are the objectives of "Social Audit"?
5. What are the natures of Environment Audit?
6. Discuss the significance of Environment Audit.
7. What do you mean by EDP Audit? [*C.U. B.Com(H), 2008*]
8. What do you mean by Social Audit? Discuss the objectives and scope of this audit. [*C.U. B.Com(H), 2006*]
9. Write a short note on Special Audit. [*C.U. B.Com(H), 2006, 2011*]
10. Write a short note on Audit Committee. [*C.U. B.Com(H), 2007*]
11. Define Social Audit and state its objectives. [*C.U. B.Com(H), 2008*]
12. What is Cost Audit? State its advantages. [*C.U. B.Com(H), 2010, 2012*]
13. What is Management Audit? What are its objectives? [*C.U. B.Com(H), 2011*]
14. What is Environment Audit? What are its objectives? [*C.U. B.Com(H), 2012*]
15. Write a note on Tax audit.
16. Explain the concept of Auditor's Independence. [*C.U. B.Com(H), 2013*]

17. What is Management Audit? Discuss its advantages. [*C.U. B.Com(H), 2013*]
18. What are the objectives of Cost Audit? [*C.U. B.Com(H), 2013*]
19. Point out the difference between Cost Audit and Financial Audit.
20. Discuss the applicability of Rule-3 and Rule-4 of the Companies (Cost Records and Audit) Rules, 2014 in respect of Cost Audit.
21. Write a short note on 'Management Audit Report'.
22. How 'Management Audit' is conducted in an organisation?
23. Distinguish between Management Audit and Cost Audit.
24. Write a short note on 'Applicability of Tax Audit'.
25. What are the objectives of Tax Audit?
26. Define System Audit. What are its objectives?
27. Mention the advantages of having System Audit in an organisation.
28. Define Environmental Auditing. What are its advantages?

## B. Essay Type Questions (8–10 marks)

1. What is Social Audit? Give your views on the objectives of Social Audit. [*C.U. B.Com(H), 1989*]
2. Define Performance Audit. What are its objects and importance? [*C.U. B.Com(H), 1990*]
3. What is meant by Social Audit? Give your views on the objective of Social Audit. [*C.U. B.Com(H), 1991*]
4. Define Propriety Audit. Distinguish between Traditional Audit and Propriety Audit. What are the benefits of Propriety Audit? Is there any provision for such audit in case of Companies under the Companies Act, 1956? [*C.U. B.Com(H), 1992*]
5. How would you differentiate Cost Audit from Performance Audit? [*C.U. B.Com(H), 1994*]
6. What is meant by Social Audit? Do you justify the introduction of Social Audit in India today? [*C.U. B.Com(H), 1994*]
7. Discuss the concept and object of Cost Audit and state who can conduct it under the Companies Act, 1956. Distinguish between Cost Audit and Management Audit. [*C.U. B.Com(H), 1996*]
8. What are the objectives of Social Audit? Discuss the position of Social Audit in Indian scenario. [*C.U. B.Com(H), 1997*]

9. Describe the objectives of Cost Audit. Who can be appointed as Cost Auditor under the Companies Act, 1956? Discuss the advantages of Cost Audit from the view point of the Management. [*C.U. B.Com(H), 1999*]
10. What is meant by Social Audit? Discuss the objectives of Social Audit. Do you justify the introduction of Social Audit in India? [*C.U. B.Com(H), 2000*]
11. Discuss the reasons for introduction of Cost Audit. Why the need for Management Audit is felt? [*C.U. B.Com(H), 2001*]
12. Discuss the provisions of the Companies Act, 1956 regarding Cost Audit. [*C.U. B.Com(H), 2003*]
13. What are the limitations of Management Audit? What additional advantages are derived from management audit when financial audit is already there? [*C.U. B.Com(H), 2004*]
14. What is Cost Audit? In which cases Cost Audit is applicable? Describe the different provisions of the Companies Act, 1956 relating to the report of Cost Audit. [*C.U. B.Com(H), 2005*]
15. Write a note on Management Audit. [*C.U. B.Com(H), 2006*]
16. What is Cost Audit and discuss its advantages. Explain the relevant provisions of the Companies Act in respect of such audit. [*C.U. B.Com(H), 2007*]
17. Write short note on:
    (a) Social Audit [*C.U. B.Com(H), 2010*]
    (b) Cost Audit [*C.U. B.Com(H), 2011*]
18. Explain the concept of Auditor's Independence by pointing out existing provisions of various Acts and Rules in support of it. [*C.U. B.Com(H), 2014*]
19. Write short notes on Tax Audit and System Audit. Mention title and corresponding number of any four standards on Auditing (SA) as issued by the ICAI till date. [*C.U. B.Com(H), 2014*]
20. What are the advantages of Propriety Audit? How does it differ from Traditional Audit?
21. Define Performance Audit. What are its objectives? How an organisation can be benefited from Performance Audit?
22. What do you mean by Professional Ethics? Mention the fundamentals principles of Professional Ethics.
23. Write a short note on 'Other Misconduct' as per the Chartered Accountants Act, 1949. What are the objectives of Professional Ethics?
24. How computerised Auditing System differs from Conventional Auditing System? Write short notes on 'White Box Approach' and 'Black Box Approach' of auditing in a CIS Environment.

# Model Questions and Answers

## CHAPTER 1 Introduction

**1. What do you mean by Audit?**

**Ans.** The term 'audit' has its narrow and broad meaning.

**(a) Narrow Perspective** The word 'Audit' is derived from the Latin word 'audire' which means 'to hear'. In early days, an auditor usually listened to the accounts read out by the accountant in order to check its authenticity. In those days, in the case of suspected fraud in an organisation, the owner of the business used to appoint a person to verify the accounts and listen to the explanations given by the person responsible for keeping the accounts and funds. Thus, in its narrow sense, the scope of an audit is limited to only authenticating the accounting records and thereby to assure the accuracy and reliability of the financial statements and reports.

**(b) Broad Perspective** With the changes in socio-economic environment, the concept of audit has been reshaped. Today, auditing is not confined to mere authentication of financial accounting records. It is now considered to be an independent appraisal activity that extends itself towards evaluation of non-financial aspects as well. Thus, in order to address the specific objectives, auditing must go beyond the numbers and reports and should also evaluate all the relevant aspects of operations and performance of the organisation in a systematic and unbiased approach. Thus, in the broader perspective, auditing is a holistic appraisal of all the relevant aspects (be it financial or otherwise) of an enquiry sought after a stated purpose.

**2. State the Objectives of Auditing.**

**Ans.** The objectives of an audit can be grouped into three categories: (a) Primary, (b) Secondary and (c) Social objectives.

**(a) Primary Objectives** The primary objective of an audit is to substantiate the accuracy and judge the reliability of the financial statements of a particular

accounting period of the organisation and to express an opinion about the truthfulness and fairness of the financial statements. Rendering opinion on financial statements by the auditor is specifically included in SA 200.

**(b) Secondary Objectives** The following are the secondary objectives of audit:

**(i) Detection of Errors** Detecting errors may or may not be easy. It depends on the type of error. It is easy to locate those errors whose occurrences result in a mismatch in the total of the trial balance.

**(ii) Detection of Fraud** Fraud is difficult to detect because in most cases, frauds are committed intelligently and top management is involved. However, an auditor can detect frauds, if he applies reasonable skill and care in the discharge of his duties.

**(iii) Prevention of Errors** Appropriate measures can be suggested by the auditor to prevent the recurrence of errors committed earlier.

**(iv) Prevention of Fraud** An auditor can suggest ways for preventing the occurrence and recurrence of frauds.

**(c) Social Objectives of Audit** In addition to the above primary and secondary objectives, audit has certain social objectives too. These are enumerated below.

**(i) To Protect Shareholders' Interest** Since the auditor is a representative of the shareholders, it is his duty to ensure that the interest of the shareholders is protected. In a corporate organisation, shareholders are large in number but they are scattered and not united. Most of them have no idea about their rights and duties and as such, they are vulnerable in the hands of the unscrupulous management. Hence, protecting the interest of the shareholders is an important social objective of audit. This can be done by the auditor by bringing any irregularity to the notice of the shareholders through his audit report and, thereby, making them aware about the ill intentions of the management, if any.

**(ii) To Stop Tax Evasion** In order to protect the national interest, it is absolutely essential that tax evasion should be stopped. Evasion of tax is a moral, social, and legal crime which adversely affects the developmental agenda of a nation by reducing the revenue of the government. Thus, the objective of an audit should be to stop tax evasion. Propriety audit, etc. are extremely helpful in this context.

**(iii) To Safeguard against Capital Erosion** Capital erosion results from payment of dividend out of inflated profit or payment of dividend out of unrealised profit. This is very serious in the sense that it may lead to winding up of the business. Therefore, one of the important social objectives of audit is to stop capital erosion by introducing innovative audit approaches like management audit, propriety audit, cost audit, operation audit, etc.

**(iv) To Ensure Fair Return to Investors** An important social objective of an audit is to ensure a fair return to the investors. The auditor may suggest appropriate corrective actions in policies and operations that have been found to misuse resources and, thereby, can contribute to enhance the profitability of the organisation.

**(v) Reasonable Price for Consumers** It is an important social objective of an audit to make sure that the consumers get the commodities at a fair and reasonable price. Therefore, the auditor must report to the shareholders all such instances where the management has unnecessarily shifted any burden of loss or cost on the consumers and, thereby, has increased the price illegitimately.

**(vi) Fair Wages for Labourers** Another important social objective of an audit is to ensure fair wages for labourers. It is essential to verify whether wages for labourers have been cut or reduced in the plea of labour cost control. Moreover, the auditor must also bring to the notice of the shareholders and public any instances of violation of fair wages policy accepted in an industry.

**(vii) Complying with Policies Regarding Corporate Social Responsibility** The Companies Act, 2013 has put emphasis on matters relating to 'Corporate Social Responsibility'. As per Section 135 of the Companies Act, 2013, companies belonging to the specified class must constitute a Corporate Social Responsibility Committee of the Board, which shall spend, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy. Thus, it shall be the objective of the auditor to verify whether the company has followed the said provisions. Any violation of the said provisions shall be immediately brought to the notice of the shareholders through appropriate qualifications in this final report.

**3. Discuss different types of Errors.**

**Ans.** Mistakes committed unintentionally and unknowingly at any stage of accounting are termed as errors. Errors can broadly be classified into five categories, viz., (a) Errors of Commission, (b) Errors of Omission, (c) Errors of Duplication, (d) Compensating Errors, and (e) Errors of Principle. These are discussed below.

**(a) Errors of Commission** Errors arising out of wrong posting (either wholly or partially), wrong totaling, wrong calculations, wrong balancing and wrong carry forward are termed as errors of commission. Some of these errors may affect the trial balance while some others may not.

**Example**

(i) Purchase of goods for ₹ 10000 may be entered as ₹ 1000 in the Purchase Day Book. This error will not affect the trial balance.

(ii) Purchase of goods for ₹ 10000 posted to the debit side of supplier's account. This error will not affect the trial balance.

**(b) Errors of Omission** Such errors arise when transactions are not recorded either wholly or partly in the books of accounts. Full omission takes place if a transaction is not at all recorded in the books of original entry.

**Example**

(i) Goods sold to Mr. X for ₹ 10000 were not recorded in the Sales Day Book at all. On the other hand partial omission occurs when a transaction is recorded partially.

(ii) Goods sold to Mr. X for ₹ 10000 was not posted to Mr. X A/c. Error due to full omission will not affect the trial balance and hence, is difficult to detect. On the other hand, errors due to partial omission will affect the trial balance and can be detected easily.

**(c) Errors of Duplication** Such errors arise because of double recording of the same transaction. Double posting of a transaction from journal to ledger create such errors as well.

**Example**

(i) Goods sold to Mr. X have been recorded twice in the primary books. This error will not affect the trial balance.

(ii) Goods sold to Mr. X have been posted twice in the account of Mr. X. This error will affect the trial balance.

**(d) Compensating Errors** When two errors are committed in such a way that effect of one gets offset by another, they are known as compensating errors.

**Example** Peter's account which was to be debited for ₹ 10000 was debited for ₹ 1000 and similarly, John's account which was to be credited for ₹ 10000 was credited by ₹ 1000. These two errors nullify the effect of each other. Hence, they are compensating error.

**(e) Errors of Principle** Such errors take place when, at the time of recording a transaction, the fundamental principles of accounting are not properly followed. Incorrect allocation of expenditure between capital and revenue, incorrect presentation of items in financial statements are some of the reasons for such errors.

**Example** Wages paid on installation of Machinery wrongly debited to Wages account.

This type of errors occurs due to lack of knowledge of sound principles of accounting or can even be committed purposely to forge the accounts. In order to detect such errors, the auditor has to carry out a vigilant inspection of the books of account.

**4. 'Auditing is a dynamic Social Science'. – Discuss.**

**Ans.** The term "social science" refers to any **scholastic discipline that focuses on the disciplined and systematic study of society, investigates problems of human society and renders direct or indirect services to the society**. Social science covers a broad range of disciplines. Examples of social science are anthropology, sociology, economics, psychology and political science, etc. All these subjects or branches of knowledge systematically study the society and its problems and attempt to devise various principles to overcome such problems. Likewise, auditing also systematically studies the operations of a business or any other entity which is basically a part of the society. Auditor's comment on the accuracy and reliability of the financial statements of a business entity is of immense value to all stakeholders associated with that entity. Auditing has its social objects like protecting the interest of investors, shareholders, labourers and consumers, preventing capital erosion and to stop tax evasion in national interest. These are likely to have direct or indirect positive impact on the societal wellbeing. Thus, auditing can rightly be called a social science

Moreover, social science is 'dynamic' and evolves with the passage of time by accommodating required changes. Auditing is also dynamic and modifies itself in response to the changes in law or regulations and stakeholders' expectations. Historical evidences indicate that accounting and auditing existed even in ancient Greece, Rome, Egypt and India. However, the scope of audit was very limited in that period. In eighteenth century, industrial revolution in England led to the development of corporate form of organisations. Management got separated from ownership and volume of transactions increased enormously. As a result, auditing techniques also started evolving from this phase. Subsequently, the Companies Act made audit of companies mandatory and professional institutes started issuing rules and regulations for improving the quality of auditing around the globe. All these continuously changed the form, techniques, scope and objectives of auditing profession. Thus, the dynamic character of auditing can never be ignored.

Hence, there is no denying the fact that auditing should also be considered as a dynamic social science.

**5. 'Fraud does not always mean Misappropriation of Cash or Goods'. – Comment.**

**Ans.** The term 'fraud' refers to intentional misstatement or misappropriation and essentially involves deception for the purpose of obtaining any illegitimate advantage. It is an intentional false representation with some mischievous objectives.

Fraud may be of two types: (A) Misappropriation of assets and (B) Manipulation or falsification of accounts.

**A. Misappropriation of Assets**

Misappropriation of assets may again be of two types: (a) Misappropriation of cash and (b) Misappropriation of other assets.

**(a) Misappropriation/Embezzlement of Cash**

In an entity, cash may be misappropriated in the following ways–

(i) Embezzling receipts, for example – misappropriating collection from customers, diverting bad debt recovery to personal accounts.

(ii) Recording payments to fictitious accounts, for example – payments to fictitious suppliers, payments to fictitious employees, recording fictitious expenses.

Misappropriation of cash is an easy affair, especially in large concerns.

**(b) Misappropriation of Other Assets** In an entity, assets other than cash may also be misappropriated. Some of the instances are–

(i) Stealing physical assets, for example – stealing inventory from store, stealing scrap for resale, etc.

(ii) Stealing intellectual property, for example – disclosing technological secrets to competitors for personal gain.

(iii) Using entity's assets for personal use, for example – using entity's assets as collateral for personal loan.

**B. Manipulation or Falsification of Accounts**

It involves intentional misstatements including omission of transaction or disclosures in financial statements to defraud the users of financial statements. Fraudulent financial reporting can be accomplished in three ways–

(a) Manipulation, falsification or alteration of accounting records or supporting evidences, for example – concealing facts that could affect the numbers recorded in the financial statements, altering records of transactions.

(b) Misrepresentation in or omission from financial statements of events, transaction or other relevant information, for example – omitting, delaying or advancing recognition of transactions and events in the financial statements.

(c) Misapplication of accounting principles relating to classification, estimation, presentation and disclosure. For example – inappropriately changing assumptions and judgments used to estimate account balances.

**6. Discuss the Principles of Auditing.**

**Ans.** The basic principles governing an audit are stated below.

**(a) Integrity, Objectivity and Independence** The auditor has to be straightforward, fair, impartial, honest and sincere in his approach to his professional work.

**(b) Confidentiality** The auditor should uphold the privacy of the information and should not disclose any such information to a third party, including the employees of the entity, without the explicit authority of the management or client or unless there is a lawful or a professional responsibility to do so.

(c) **Professional Care, Skill & Competence** The auditor should exercise due professional care, competence and diligence expected of him while carrying out the audit work.

(d) **Responsibility of Work Performed by Others** The auditor should carefully direct, oversee and review the work delegated to staff. Likewise, the auditor may also use the work done by other auditors or experts.

(e) **Documentation** The auditor should document matters, which are essential in providing evidence that the audit was carried out in accordance with the Standards.

(f) **Planning** The auditor should plan his work to enable him to conduct an audit in a timely and efficient manner. The audit plan should be based on the knowledge of the business of the entity. The plan should be continuously reviewed and modifications should be incorporated, if required.

(g) **Audit Evidence** The auditor should get hold of enough suitable evidence to enable him to draw reasonable conclusions therefrom.

(h) **Accounting System & Internal Control** The auditor should have an understanding of the internal control and risk management framework established by the management. He has to judge the adequacy of such framework as well.

(i) **Audit Conclusions & Audit Report** The auditor should review and measure the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report. Nevertheless, in case the auditor comes across any actual or suspected fraud, it would be more apt for him to bring the same instantaneously to the notice of the management.

**7. Distinguish between Periodical Audit and Continuous Audit.**

**Ans.** The differences between Continuous Audit and Periodic Audit are as given below:

| Points of Difference | Continuous Audit | Periodic Audit |
|---|---|---|
| **1. Timing** | It is conducted throughout the year. | It is conducted after the preparation of financial statements. |
| **2. Cost** | It is more costly. | It is less costly. |
| **3. Detection of error and fraud** | Early detection of error and fraud is possible and accordingly, appropriate measures can be taken to prevent their recurrence. | Early detection of error and fraud is not possible because it is carried out after the preparation of final accounts. |
| **4. Reliability** | It is more reliable. | It is less reliable. |

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| | | |
|---|---|---|
| **5. Scope** | Detailed checking is possible. | Detailed checking is not possible. |
| **6. Monotony** | The possibility of monotony can't be ruled out. | It doesn't give rise to monotony. |
| **7. Collusion** | There is a possibility of collusion between the audit staff and the employees of the organisation. | There is no possibility of collusion between the audit staff and the employees of the organisation. |
| **8. Interim dividend** | It facilitates declaration of interim dividend. | It doesn't facilitate declaration of interim dividend. |
| **9. Moral pressure** | Moral pressure on the employees of the organisation is there as the audit staff frequently visits the organisation. | There will be less moral pressure on the employees of the organisation because the audit staff visits the organisation at the end of the year. |
| **10. Applicability** | It is suitable for large organisations. | It is suitable for both small and large organisations. |
| **11. Report** | It facilitates timely audit report submission. | It takes time to prepare and submit the audit report. |
| **12. Audit programme** | Audit programme can be prepared easily because the auditor has familiarity with the nature of business and system of accounts of the organisation. | Preparation of audit programme is not that easy since it takes time for the auditor to become familiar with the nature of business and system of accounts of the organisation. |

**8. State the Differences between Internal Audit and Statutory Audit.**

**Ans.** The differences between Internal Audit and Statutory Audit are as follows:

| Points of Difference | Internal Audit | Statutory Audit |
|---|---|---|
| **1. Legal Requirement** | Internal audit is the need of management, but it is not always compulsory by law. | Statutory audit is the legal requirement. |
| **2. Qualification** | An internal auditor does not require specific qualification as per the provision of law. | The qualification of a statutory auditor is specified in the statute. |
| **3. Status** | An internal auditor is a staff who is appointed by the management. | A statutory auditor is an independent person appointed usually by the shareholders. |

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| | | |
|---|---|---|
| **4. Report** | Internal auditor needs to give suggestions to improve weaknesses, but does not need to present a report. | A statutory auditor has to prepare a report after the completion of the work on the basis of facts found during the course of audit and present such report to the appointing authority. Giving recommendations is not a part of his duty. |
| **5. Appointment and Removal** | An internal auditor is appointed by the management. Similarly, he can be removed from his post by the management without any legal formalities. | In the case of company form of business, the statutory auditor is appointed by the shareholders (in most cases), or by the board of directors, or by the Central Government. Removal of the statutory auditor is governed by the provisions incorporated in the concerned statute. |
| **6. Duties and Liabilities** | Duties and liabilities of an internal auditor are determined by the management. | Duties and liabilities of the statutory auditor are specifically incorporated in the concerned statute. |
| **7. Scope** | It may be a complete audit or partial audit as per the decision of the management. | It must cover all the aspects as stated in the concerned statute. |

**9. Explain the Advantages of Continuous Audit.**

**Ans.** The advantages of Continuous Audit are given below:

**(i) Easy and Early Discovery of Errors and Frauds** Under continuous audit, errors and frauds can be discovered early and easily as the accounts are verified in detail at regular intervals by the audit staff.

**(ii) Valuable Suggestions** Since in a continuous audit, the auditor is in constant touch with the business, he is in a better position to make valuable suggestions for the improvement of the concern.

**(iii) Timely Presentations of Accounts** Under continuous audit, vouching and verification is performed continuously during the year. Hence, the final audited accounts can be prepared soon after the close of the financial year.

**(iv) Moral Cheek on the Staff** Continuous audit involves regular visit of the auditor/audit staff to the client's office. This puts a moral check on the staff in preparing the accounts.

**(v) Preparation of Interim Accounts** Continuous audit facilitates preparation of the interim accounts quickly which enables the directors of a company to declare an interim dividend.

**(vi) Declaration of Final Dividend** Timely preparation of interim accounts facilitates timely finalisation of accounts after the end of the year and timely declaration of final dividends.

**(vii) Proper Audit Plan** Because of his frequent visit, here it is possible for the auditor to become familiar with the nature of business and system of accounts of the organisation. As a result, he can prepare his audit plan properly which ensures proper allocation of work amongst the audit staff.

**(viii) Healthy Relationship** There is always a possibility of developing a healthy relationship between the audit staff and the client's staff because here the audit staff visits the organisation frequently. Such a healthy relationship can, many a time, avoid conflict.

## CHAPTER 2 Audit Procedures and Techniques

**1. What is an Audit Programme?**

**Ans.** Before commencing the actual audit work, every auditor generally prepares a detailed programme of work. This is popularly known as Audit Programme. Thus, audit programme may be defined as a carefully drawn detailed plan of audit work clearly specifying the responsibilities of the audit staff and time allotted to perform the same after incorporating precautionary arrangements against potential errors, frauds and omissions, in order to perform the functions of auditing in an efficient and effective manner.

**2. What is Audit File?**

**Ans.** The file which is used by the auditor to preserve all the important documents relevant for the audit of an organisation is known as audit file. It basically acts as the archive of all the important statements, notes, etc. generated during the conduct of audit of the organisation.

According to SA 230, 'Audit Documentation', audit files are defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise of audit documentation for a specific engagement.

**3. What is an Audit Memorandum? Is it different from Audit Programme?**

**Ans.** Before the commencement of audit work, every auditor must obtain detail understanding about the structure of the organisation and its operating policies. This information can help the auditor a lot in determining the scope and process of auditing. Audit memorandum may be defined as the statement that contains all the above information in an organised manner.

Audit programme, on the other hand, may be defined as a carefully drawn detailed plan of audit work clearly specifying the responsibilities of the audit staff and time allotted to perform the same.

**4. What do you mean by Audit Working Papers? Can an Auditor keep the Audit Working Papers with himself?**

**or**

**What is Audit Working Paper? Discuss about the Ownership and Custody of Audit Working Papers mentioning the Relevant Auditing Standard and Decisions of Case Laws.**

**Ans.** As per SA 230, 'Audit Documentation', audit working papers (also called audit documentation) refer to the record of audit procedures performed, relevant audit evidences obtained and conclusions the auditor reached. Such records can be kept either in physical form or in an electronic form.

The issue whether an auditor can keep the audit working papers with himself is debatable. Significant differences of opinion exist in this respect. One view has been that the audit working papers should be the property of the client. This is because such papers are prepared based on the client's books of accounts and other documents provided by him and contains confidential information about his business. Thus their ownership must lie with the client as otherwise the confidentiality may be compromised. The other view, however, contends that audit working papers contain information procured and evaluated by the auditor in properly discharging his duties. Therefore, the auditor can easily defend himself against any future allegation of negligence based on the working papers. Hence, it is the auditor who should be the sole owner and custodian of the working papers.

In this respect decisions of a few notable case laws can be mentioned here. In *Leicestershire County Council* vs. *Michael Faraday and Partners Ltd*. (1941), it was held that if the auditor acts as an agent of the client such as to resolve any income tax dispute, etc., he cannot claim any right over the working papers. Similar to this decision, in *Sockockinsy* vs. *Bright Graham and Co*. (1938), it was held that an auditor is an independent evaluator and not an agent of the client and accordingly, all working papers prepared by the auditor in the course of the audit should belong to the auditor only. In *Chantrey Martin and Co*. vs. *Martin* (1953), the court recognised the difference between an auditor's role as an independent professional and that as an accountant or expert, being an agent of the client. It was held that when the auditor acts as an independent professional, he himself will be the owner of all working papers.

Currently, the above controversy has been resolved by the professional bodies through different regulatory pronouncements. In India, as per SA 230, 'Audit Documentation', audit working papers are the property of the auditor and not of the client. On request, the auditor can handover the same to the client, if he wants. But the client cannot compel him to do so. However, since the working papers contain confidential information about the business of the client, it will be the duty of the auditor to maintain high degree of confidentiality regarding the same and preserve them for a period of time sufficient to meet the needs of his practice and satisfy any future legal requirements.

**5. Mention any six important items included under Audit Engagement Letter.**

**Ans.** As per SA 210, 'Agreeing the Terms of Audit Engagements', the audit engagement letter should contain the following:

(a) The objective and scope of audit of financial statements.
(b) The responsibilities of the auditor.
(c) The responsibilities of the management as regards to –

(i) Selection of accounting policies.
(ii) Consistent application of the accounting policies selected.
(iii) Preparation of financial statements on a going concern basis.
(iv) Maintenance of adequate accounting records and internal control, etc.

(d) Unrestricted access to all records, documentation and other information required in audit.
(e) Possibility of frauds remaining undetected because of test nature of audit.
(f) The fact that audit process may be subject to a peer review under Chartered Accountants Act, 1949.

**6. How can the disadvantages of Traditional/Fixed Audit Programme be removed?**

**Ans.** Though an audit programme offers substantial benefits, using a fixed programme may also create problems at times which can significantly deter the quality of the audit work. In this respect, the following steps may be taken to remove the short-comings of a fixed audit programme.

**(a) Educating the Audit Staff** The audit staff should be clearly informed about the purpose of the audit programme. They should be told that they may go beyond the programme, if the situation so demands. If possible, their opinion should also be considered while preparing the audit programme.

**(b) Initiating Changes Based on Circumstances** Instead of following the same programme year after year, the auditor may initiate appropriate changes based on circumstances. This will remove monotony of the audit staff engaged in the audit work.

**(c) Rotation of the Audit Staff** Instead of allocating the same job to the same person repetitively, the auditor may rotate the duty of the staff. This will increase their drive and initiative.

**(d) Review of the Work of the Audit Staff** The performance of the audit staff should be regularly reviewed through surprise check. This will keep them ever alert and more dedicated to their duty.

## CHAPTER 3 Internal Control and Internal Audit

**1. Discuss the objectives of Internal Check.**

**Ans**. In an organisation, internal control is the holistic and minutely planned control system whose prime objective is to conduct the activities of the organisation in an orderly manner. However, within this prime objective, the specific objectives are as follows:

**A. Authorisation**

An important objective of internal control is to ensure that all transactions are approved by the responsible personnel in accordance with specific or general authority.

**B. Completeness**

Another objective of internal control is to ensure that the books of accounts is completed in all respect and no valid transaction has been omitted from the accounting records.

**C. Accuracy**

An important objective of internal control is to ensure that all valid transactions are accurately recorded, consistent with the originating transaction data and information is recorded in a timely manner.

**D. Validity**

Internal control should also ensure that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorisation.

**E. Physical Safeguards and Security**

It must ensure that access to physical assets and information systems are controlled and properly restricted to authorised personnel.

**F. Error Handling**

Internal control should ensure that errors detected at any stage of processing receive prompt corrective action and are reported to the appropriate level of management.

**G. Segregation of Duties**

Another objective of internal control is to ensure that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures related to processing of the same transaction.

In this respect SA 315 on Risk Assessment and Internal Control, advocates the following objectives of internal control:

(i) To ensure that transactions are executed as per management's authorisation.
(ii) To ensure that transactions are recorded in proper way to facilitate preparation of financial information for maintaining record of assets.
(iii) To ensure that assets are protected from unauthorised use, sale, etc.
(iv) To ensure that assets are verified at frequent intervals.

**2. Discuss the Internal Check System of Receipt of a Cinema Hall.**

**Ans**. The main sources of income of a cinema hall include sale of tickets, receipts from advertisement, receipts from restaurant attached with the hall, rent from shops attached with the hall, etc. Thus, the internal check system should include the following:

**A. Sale of Tickets**

(i) Entry to hall must be allowed through printed purchased tickets only. Only the hall manager should have the right to issue free pass.
(ii) Tickets should have serial numbers.
(iii) Preparation of statement of tickets sold should be mandatory to verify it with the actual cash receipts.
(iv) Statement of tickets sold should be authenticated by booking clerk and cashier.
(v) Cash receipts should be entered in the cash book.
(vi) Cash receipts should be deposited in the bank on the next day.
(vii) Unsold tickets need to be preserved safely in the custody of a competent authority.

**B. Advertisement Receipts**

(i) Tariff rates of advertisements should be determined on the basis of time.
(ii) All receipts must be in a/c payee cheques only.
(iii) Written contract for each advertisement should be there.

**C. Receipts from Restaurants**

(i) When cash is received from sales, it should be recorded in a rough cash book before posting it to the final cash book. At the end of each day, the cash sales recorded should be verified with physical cash first before final posting to main cash book.
(ii) Amount of sales recorded daily should be authenticated by at least two responsible officers.
(iii) All cash sales should not be handled by one staff, and the work load should be distributed.

**D. Rent from Shop (if any)**

(i) If there is any shop attached to the hall, the rent to be paid to the hall by the shopkeeper should be in a/c payee cheque issued in the name of the hall.

(ii) After receiving the cheque, the hall should record it in main cash book and then deposit the same into bank.

(iii) If any cheque takes time to get cleared then the matter should be probed into by hall authority.

(iv) Finally, preparation of bank reconciliation statement, preferably on monthly basis, should be mandatory to tally cash and bank balance.

**3. Can an Auditor, while performing his function as a Statutory Auditor, rely on the Internal Check System? Discuss.**

**Ans.** In an organisation, an auditor is appointed to authenticate the books of accounts and final financial statements based on all available evidences. He is also to express an unbiased opinion on the exhibition of true and fair view of the financial performance and financial state of affairs through the income statement and the balance sheet, respectively. Thus keeping in mind such an objective, the auditor needs to decide the extent of examination that he should conduct to arrive at any conclusion. The auditor, in this context, can resort to either detailed checking or test checking. Detailed checking refers to the examination of books of accounts in detail. Test checking, on the other hand, is the technique of checking some transactions selected as sample from the group of transactions and drawing conclusion on that basis, taking sample transactions selected to be the representative of the remaining transactions. Detailed checking is time consuming as well as laborious whereas test checking relieves the auditor from such pain. Thus, in actual practice, often the auditor is found reporting to test checking, provided the internal check system is satisfactory. Reliance on an effective internal check system and, thereby, streamlining the audit process enables the auditor to devote more time in examining the critical areas of accounting including valuation of closing stock, valuation of assets and liabilities, determining the reasonableness of provisions, etc.

However, such reliance simultaneously increases the risk of the auditor. This is because even a sound internal check system can not guarantee the non-existence of any error or fraud in the accounts. Thus, when the auditor applies test checking instead of a detailed checking, there is every possibility that any such error or fraud remains undetected. In such a situation, the auditor cannot escape his responsibility on the ground that he relied upon the existing internal check system of the organisation, rather he will be held liable for negligence in his duty. This was also held in the famous Case Law of *Mc. Bride Ltd* vs. *Rooke and Thomas, Canada* (1941). In this case, the honourable judge concluded that an auditor cannot be relieved from his liability for non-detection of material errors and frauds simply on the ground that he depended on the internal check system.

Thus the auditor should always keep in mind that resorting to test checking by relying on internal check system of the organisation no way reduces the liability of

the statutory auditor. If any error or fraud is detected afterwards he will be held liable for being negligent in his duty. Therefore, if an auditor relies on internal check system and tries to make his work short and simple, he must do so at his own risk.

**4. Can the Statutory Auditor rely upon the work of an Internal Auditor? Justify your answer mentioning relevant SA.**

**Ans**. SA 610 (earlier AAS 7), issued by ICAI states that the external auditor can use the work of the internal auditor after evaluation of internal audit functions.

Accordingly, the following factors should be considered while determining the extent to which the external auditor can rely on the work of the internal auditor:

(i) whether internal audit is undertaken by outside agency or by a separate audit department within the entity

(ii) the scope of internal audit, management action and the internal audit report

(iii) experience and qualification of the internal auditor

(iv) the technical compliance by internal auditor

(v) authority vested on the internal auditor and the level of management to whom he is accountable

(vi) whether professional care has been taken by the internal auditor in conducting the audit work.

The above statements suggest the following features:

- The role of the internal auditor is determined by the management and differs from that of the external auditor.
- External auditor should evaluate the internal audit function to the extent it is relevant for determining nature, timing and extent of his compliance and substantive procedures.
- The responsibility of the external auditor cannot be reduced due to reliance on the work of the internal auditor.

Thus, to conclude, it can be said that the external auditor can rely on the work of the internal auditor, but if any misstatements remain undetected, the external auditor will be held liable for negligence in his duty.

## CHAPTER 4 Audit Sampling and Analytical Procedure

**1. What do you mean by 'Audit Sampling'?**

**Ans.** According to SA 530 on 'Audit Sampling' issued by ICAI, sampling in the context of auditing is the application of audit procedures to less than 100% of the items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusion about the entire population. In other words, audit sampling is the process of selecting a limited number of transactions out of the total transactions of a given category (known as population) using a reasonable basis and applying the audit procedures on the selected transactions to form an opinion about the entire category.

**2. What do you mean by Sampling Risk?**

**Ans.** Since sample is only a selected part of the population, it can never reflect all the characteristics of the population. Accordingly, results obtained from sample units are bound to differ from that of based on entire population, at least to some extent, irrespective of the sample size or the method applied for sample selection. This error is known as sampling error. Audit sampling is also subject to this error and the corresponding risk is known as sampling risk.

**3. Do you think Audit Sampling helps an Auditor in decision making? Is the use of Audit Sampling accepted? Explain the term Stratified Sampling.**

**Ans.** In case of a large organisations, with adequate internal control system in force, it is neither feasible nor desirable to verify each and every transaction to come to a conclusion on the disclosure of true and fair view of financial performance and state of affairs. The auditor, in such a situation, should certainly apply partial checking to form his opinion. However, the success of partial checking largely depends on appropriate sample selection. Hence, it is imperative that the auditor should have sufficient knowledge regarding sampling technique.

According to SA 500 on 'Audit Evidence' issued by ICAI, an auditor may use audit sampling in selecting items required to conduct an effective test to provide appropriate audit evidence to the extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. Therefore, there is no legal restriction on using audit sampling.

*Stratified Sampling*: This method requires a given heterogeneous population to be first divided into a number of sub-populations (known as stratum) with homogeneous items and then selecting equal or unequal proportions of items from each group to form a representative sample of reasonable size. For example, trade receivable balances may be divided into five groups as –

(1) Balances in excess of ₹ 5,00,000
(2) Balances in between ₹ 3,00,001 to ₹ 5,00,000
(3) Balances in between ₹ 1,00,001 to ₹ 3,00,000
(4) Balances in between ₹ 20,001 to ₹ 1,00,000
(5) Balances up to ₹ 20,000.

The auditor may then decide to vouch all the transactions from the first group, 50% transactions of the second, 25% of the third and fourth groups and 5% transactions of the last group. Alternatively, if thought appropriate, he may pick up equal percentage of transactions from each group.

**4. What do you mean by Analytical Procedure in Auditing?**

**Ans.** Analytical procedure may be defined as the process to carefully study the relationship between various financial and non-financial data, analysing their behaviour or pattern to identify any unusual deviation from the expected value of the item or any inconsistency with the relevant information and the reason thereof. According to SA520 on 'Analytical procedures', analytical procedure means evaluation of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

**5. Briefly discuss four methods of Sample Selection under Audit Sampling.**

**Ans.** The four methods of sample selection under audit sampling are as follows:

A. **Random Sampling** In this method of sampling, each item of the population or within a given group (popularly known as stratum) has a known chance of selection. Random sampling can again be of two types –

**(i) Simple Random Sampling** Under this method of sampling, each unit of the population has an equal chance of being selected in the sample. Here, selection is normally done either by choosing a random number manually from a random number table or allowing the computer program to select a random number and then identifying the population unit that corresponds to the random number by using any predefined rule. However, this method essentially requires the population units to be reasonably homogeneous or similar in nature.

**(ii) Stratified Sampling** This method requires a given heterogeneous population to be first divided into a number of sub-populations (known as stratum) with homogeneous items and then selecting equal or unequal proportion of items from each group to form a representative sample of reasonable size. For example, trade receivable balances may be divided into five groups as –

(1) Balances in excess of ₹ 5,00,000
(2) Balances in between ₹ 30,001 to ₹ 5,00,000
(3) Balances in between ₹ 10,001 to ₹ 3,00,000
(4) Balances in between ₹ 20,001 to ₹ 1,00,000
(5) Balances up to ₹ 20,000.

The auditor may then decide to vouch all the transactions from the first group, 50% transactions of the second, 25% of the third and fourth groups and 5% transactions of the last group. Alternatively, if thought appropriate, he may pick up equal percentage of transactions from each group.

**B. Systematic/Interval Sampling** This method requires selecting items using a constant interval between selections with the first selection being random. The interval can be based on a number (like every $30^{th}$ item in the list) or a monetary value (like ₹ 30,000 of cumulative value of the last selection). Though this method seems very easy, the auditor must ensure that the population is not structured in a manner that the interval always corresponds to a pattern in the population. Systematic sampling can again be of two types:

**(i) Block Sampling** This method requires selection of a defined block of consecutive items. For example, the auditor may select first 100 entries of the purchase day book for the month of July or any two blocks of 50 purchase items from July. Thus, once the first item is selected, the next 49 items of the block will normally follow it for selection. This method is simple and economical. But, there is also possibility of bias.

**(ii) Cluster Sampling** Under this method, the population is first divided into a number of groups known as clusters (for example, purchase and sales invoices are kept in months or wage records are kept in weeks). The auditor then selects a number of clusters randomly instead of selecting individual items of population. Selection of clusters can be made using random number tables. In the next stage, the items in the clusters can be checked either completely or a proportion of them may be examined. Cluster sampling saves time which may be utilised to consider larger samples to enhance the reliability of sample results. However, as a method, it is outperformed by random or stratified sampling which selects individual items directly from the population.

**C. Monetary Unit Sampling** This method uses the monetary value of the transaction rather than the items as the basis for sample size determination and item selection. It is also known as value based sampling or Value weighted sampling.

**D. Multi-stage Sampling** This method is suitable when data are stored in more than one level. For example, an organisation may have stocks stored at a number

of shops. Here, the first step would be to randomly select a few shops and then to randomly select a few stock items from the shops already selected. If applied cautiously, this method proves to be very effective.

**6. 'Test checking is based on a presumption' – What is the presumption?**

**Ans.** The concept of test checking is based on the presumption of 'Sampling Theory' in Statistics. According to this theory, a well representative sample will always reflect most of the characteristics of the aggregate, i.e., population (law of statistical regularity). Moreover, as the sample size increases, the deviations between the results based on sample and that of aggregate or population will get reduced (law of inertia of large numbers). To combine the both, a representative sample of sufficiently large in size will reflect almost all the characteristics of the population with minimum error. Thus, during the course of auditing of a large number of similar transactions, a test checking based on a well representative sample with adequate size will surely help the auditor to form an opinion about the entire group.

**7. Discuss the stages involved in Audit Sampling.**

**Ans.** Audit sampling requires the following steps:

**(a) Sample Design** At this stage, the auditor should carefully consider the objectives of sampling and the nature of the population units. Based on this consideration, he must finalise the sampling method. For example, if population units are mostly homogeneous, simple random sampling may be adopted.

**(b) Sample Size Determination** Sample size should be so determined that it would minimise the sampling risk. Sample size can be determined by the application of a statistics based formulae or by professional judgment of the auditor.

**(c) Sample Selection** Sample units should be so selected that each sample becomes a representative of the population concerned and bias, if any, is avoided.

**(d) Performing Audit Procedures** The auditor, then, perform the audit procedure on each item selected. If the procedure is not applicable on a selected item, it should be performed on a replacement item. If the auditor is unable to apply the procedure at all, it will be considered as a deviation from the prescribed control (in case of test of control) or a misstatement in case of a test of details.

**(e) Nature and Cause of Misstatements** The auditor shall identify the nature and cause of misstatement to evaluate its possible impact on the purpose of auditing. The auditor must be least assured whether or not such misstatement is a representative of the population.

**(f) Projecting Misstatements** In case of test of details (i.e., vouching and verification), the auditor must project misstatements found in the sample to the

population. However, for test of control (i.e., testing the effectiveness of internal control), no explicit projection is required.

**(g) Evaluating the Results of Audit Sampling** Evaluation of the results may raise the following situations:

(i) In case of test of control, a high degree of sample deviation will lead to an increase in the assessed risk of material misstatements.

(ii) In case of test of details, an unexpectedly high misstatement amount will mean that a class of transaction or account balance is materially misstated. In such a situation, if the projected misstatement is higher than the tolerable misstatement, the auditor will conclude that the sample does not provide a reasonable basis for the population tested.

(iii) In the above case, the auditor will either ask the management to investigate the misstatements identified as well as the potential misstatements, if any, and to undertake necessary adjustments; or modify the nature, timing and extent of those audit procedures to achieve better results. For example, the auditor may increase the sample size or test an alternative control.

**8. Explain Sampling Risk involved in –**
**(a) Compliance Procedure**
**(b) Substantive Procedure**

**Ans.** Since sample is only a selected part of the population, it can never reflect all the characteristics of the population. Accordingly, results obtained from the sample units are bound to differ from that of based on the entire population, at least to some extent, irrespective of the sample size or the method applied for sample selection. This error is known as sampling error. Audit Sampling is also subject to this error and the corresponding risk is known as sampling risk. According to SA 530, sampling risk may be classified into two broad categories as follows:

**(i) Sampling Risk associated with Compliance Procedure** Compliance procedure, also called test of control, is basically the process of evaluating the soundness of the internal control system of the organisation. While applying compliance procedure on internal control, the auditor faces two kinds of risk –

- The auditor may conclude that the controls are more effective, while they are not. This may be called the risk of over reliance. This type of erroneous conclusion will lead to inappropriate audit report.
- Alternatively, the auditor may conclude that the controls are less effective, while they are not. This is the risk of under reliance. This type of erroneous conclusion will lead to additional audit work.

**(ii) Sampling Risk associated with Substantive Procedure** Substantive procedure, also known as the test of details, is defined as the process of evaluating the validity and appropriateness of the data generated through the system of recording transactions. This process aims to identify misstatements. While applying substantive procedure on transaction, the auditor again faces two kinds of risk –

- The auditor may conclude that there are no material misstatements, while they do exist. This is known as the risk of wrong acceptance. Wrong acceptance makes the audit report simply untrustworthy.
- Alternatively, the auditor may conclude that there are material misstatements, while they do not exist. This is called the risk of wrong rejection. This significantly increases the load of the audit work.

Unfortunately, both the risks in each category of procedures create hazards for the auditor and hence, should be avoided to ensure the quality of audit work.

## CHAPTER 5 Vouching

**1. Do you think that Routine Checking and Vouching are complementary to each other? As an Auditor how would you vouch the following?**

**(A) Preliminary Expenses**
**(B) Travelling Expenses**

**Ans. Routine Checking and Vouching** Routine checking means checking the arithmetical accuracy of books of original entry and ledgers with a view to detect clerical error and fraud of a very simple nature. Routine checking includes the following:

(a) Checking casts, sub-casts, carry forwards, extensions and other calculations in the books of original entry;
(b) Checking transfer of transactions from original books of accounts to ledger account;
(c) Checking debit and credit side of various accounts;
(d) Checking transfer of balances of various accounts to other pages or accounts or statements;
(e) Checking of totalling and balancing of the ledger accounts and of the preparation of trial balance made with those balances; and
(f) Overall examination of writing up the transactions properly.

In short, the routine checking is concerned with the ascertainment of the arithmetical accuracy of casting, posting and carry forward of balances.

Vouching means the inspection of receipts with the transactions of a business together with documentary and other evidences of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorised and are correctly recorded in the books. Some are of opinion that the two routine checking and vouching are the same. Some are of opinion that they are complementary to each other. So, there is a need to examine the exact relationship between these two. Routine checking is confined to examine the arithmetic accuracy of the books of account. But vouching is done to find out errors and frauds and to know the authenticity, accuracy and reliability of books of accounts. The following points may be summarised in this regard:

(a) In a broad sense, routine checking is a part of vouching. Vouching includes routine checking, checking of all totals, sub-totals, carry forwards, postings and checking of all ledgers.
(b) The scope of vouching is much wider than routine checking. Routine checking is confined to books of accounts only, where as vouching may go beyond books of accounts to trace the authenticity of the transactions.
(c) Routine checking is limited to verify the arithmetical accuracy of the books but vouching may require audit in depth or more investigation.
(d) Routine checking can discover minor errors and frauds, but major frauds or planned frauds can be traced through vouching.
(e) Routine checking is normally done by a junior audit clerk but a senior audit clerk used to perform vouching.

So, we can say that routine checking and vouching are not similar in nature and also they do not complement each other.

**A. Vouching of Preliminary Expenses**

Preliminary expenses are the expenses that the company incurs for creation of the company prior to its incorporation. The examples are stamp duties, registration fees, legal costs, accountant's fees, cost of printing, etc.

***Documents Required***
- Resolution of the Board of Directors
- Board's Minute Book
- Receipts for the registration fees paid
- Bills, receipts issued and statements
- Prospectus
- Statutory report
- Other supporting papers and vouchers

*Procedures followed/Duty of an Auditor*

(a) The auditor should examine the contracts relating to preliminary expenses.

(b) He should check the resolution of the Board of Directors and the power in the Articles if preliminary expenses incurred by promoters have been reimbursed to them by the company.

(c) All the documents supporting preliminary expenses like bills, statements, etc. should be examined.

(d) The auditor should ensure that all the expenses capitalised as preliminary expenses are actually connected with the formation of the company.

(e) The auditor can cross check the amount of preliminary expenses with that disclosed in the prospectus, statutory report and the balance sheet.

(f) He should ensure that shareholders approval has been taken for any expense in excess of the amount disclosed in the prospectus.

(g) Underwriting commission and brokerage paid for shares and debentures should not be included under the head preliminary expenses.

(h) The auditor should ensure that appropriate accounting standard and the accounting policy of the concern have been followed for writing off of preliminary expenses.

**B. Vouching of Travelling Expenses**

*Documents Required*

- Cash book
- Standard form for claiming reimbursement
- Ticket of the mode of transport used
- Hotel bill
- Travelling Allowance Rules of the organisation
- Approved Tour Programmes
- Tour Report, if any

*Procedures followed/Duty of an Auditor*

(a) The auditor should check whether there is any approved rule for travelling expenses to be paid to staff. If no rule exists, he should recommend that rule to be framed to control the expenses.

(b) The voucher for travelling expenses should normally contain the following information:

  (i) Name and designation of the person claiming the amount
  
  (ii) Particulars of the journey
  
  (iii) Amount of railway or air fare

(iv) Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station

(v) Other expense claimed, e.g., porterage, tips, conveyance, etc.

(c) The auditor should examine the cash book for payments made for travelling expenses with reference to standard form for such reimbursement filled in by the claimant with his name and designation clearly indicated.

(d) He should check the counterfoil of the air ticket if the journey was undertaken by air. For travel rail or road, the amount of the fare claimed should be checked from some independent source.

(e) He should ensure that the tour was sanctioned by the proper authority.

(f) Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified in terms of rules, if any, framed by the entity in this regard.

(g) The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned.

(h) All vouchers for travelling expenses should be authorised in the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.

(i) In case of foreign travel expenses, the auditor should also examine the Reserve Bank of India's prescribed foreign exchange entitlement for such travel along with company rules in this regard.

(j) Section 309 of the Companies Act, 2013 provides that the travelling expenses of the directors for attending the Board meetings are payable, provided they have been allowed by the articles, or by a Board's resolution or, if the articles so require, by a special resolution, passed by the company in the general meeting.

**2. 'In Vouching of Payments, the Auditor does not merely check the proof that money has been paid away.'– Discuss.**

**Ans.** Vouching does not mean merely inspection of the receipts with the cash book, but includes the examination of the transactions of a business together with documentary and other evidences of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorised and are correctly recorded in the books.

Thus, the objective of vouching is not merely to ascertain that money has been paid away, but the auditor aims to obtain reasonable assurance in respect of following assertions in regard to transactions recorded in the books of account –

(i) A transaction is recorded in the proper account and revenue or expense is properly allocated to the accounting period

(ii) A transaction pertains to entity and took place during the relevant period
(iii) All transactions which have actually occurred have been recorded
(iv) All transactions were properly authorised, and
(v) Transactions have been classified and disclosed in accordance with recognised accounting policies and practices.

Thus, it is through vouching that the auditor comes to know the genuineness of transactions recorded in the client's books of account wherefrom the financial statements are drawn up.

Apart from genuineness, vouching also helps the auditor to know the regularity and validity of the transactions in the context of the client's business, nature of the organisation and organisational rules.

Thus, the auditor's basic duty is to examine the accounts, not merely to see its arithmetical accuracy, but to see its substantial accuracy and then to make a report thereon.

Hence, substantial accuracy of the accounts and emerging financial statements can be known principally by examination of vouchers which are the primary documents relating to the transactions. If the primary document is wrong or irregular, the whole accounting statement would, in turn, become wrong and irregular. Precisely auditor's role is to see whether or not the financial statements are wrong or irregular, and for this, vouching is simply imperative. Thus, vouching which has traditionally been the backbone of auditing does not merely involve checking arithmetical accuracy, but goes much beyond and aims to check the genuineness as well as validity of transactions contained in accounting records.

**3. What are the duties of an Auditor regarding missing Vouchers?**

**Ans.** In the course of the audit, the auditor may find some vouchers missing. He must make a list of all the missing vouchers and should take the following steps in this regard.

**(a) Ask for Explanation** If any voucher is missing, the concerned official should be asked to give proper explanation. If no satisfactory explanation is received, it should be further investigated.

**(b) Non-availability of Vouchers** Sometimes it is very difficult to collect some vouchers. For example, the vouchers of rickshaw-fare, taxi fare, retail purchase of some items, etc. The auditor in such cases has to judge according to the circumstances.

**(c) Materiality of Amount** The auditor should verify whether the amount involved is material. If the amount of the voucher is very small, then the auditor may not go for obtaining further clarification.

(d) **Nature of Lost Vouchers** The auditor should also examine the nature of transactions associated with the lost vouchers. If the number of transactions is very small, then the voucher is not needed.

(e) **Causes of Loss of Vouchers** If the transactions are important, and the supporting vouchers are lost, then he must know the causes of loss of vouchers. In this respect, the auditor should follow the Doctrine of Materiality.

(f) **Verification Stores** In case of purchase of goods, if the voucher is not found, then the auditor has to see whether the goods are stored, or issued to production department, or re-sold, or included in the closing stock.

(g) **Duplicate Vouchers** In some special cases, the duplicate of original voucher is to be procured.

(h) **Procurement of Vouchers** In case of transactions which should have vouchers normally, the auditor must find out the ways of getting such vouchers with utmost care and ability.

(i) **Statement of Lost Vouchers signed by high Officials** For all the lost vouchers, the auditor should make a statement of lost vouchers with the approval and signature of the higher authority.

**4. How will you Vouch the following items?**

**A. Director's Remuneration**
**B. Payment of Insurance Premium**
**C. Payment of Dividend**

**Ans.**

**A. Director's Remuneration**

***Documents to be Checked***

- Articles of Association
- Resolutions of the general meeting
- Minute book
- Agreement with the directors
- Director's attendance register
- Receipts issued by the directors
- Bank statement

***Procedures followed/Duty of an Auditor***

(a) In general, the directors are not automatically entitled to remuneration. It is paid either according to the terms of Articles of Association or in accordance with a resolution of the general meeting. The auditor should examine the Articles of Association and resolution adopted in the general meeting in order to ascertain the mode of payment.

(b) He should refer to General meeting or Board meeting resolution for the appointment and terms of appointment of the director as per Section 196 of the Companies Act, 2013.

(c) He should also check the agreement, terms and conditions of appointment of the directors.

(d) Examine Articles of Association and general meeting resolution to determine the manner of payment – monthly or at a specified percentage of the net profits of the company or partly by one way and partly by the other as per the provisions of Section 197 (6) of the Companies Act, 2013.

(e) The auditor should verify director's attendance in the board meetings and minute book, if there is provision of payment of remuneration to the directors for attending the meeting.

(f) He should ensure compliance with the provisions of Sections 197, 198 and Schedule V to the Companies Act, 2013 where appropriate regarding remunerations paid to the directors.

(g) He should examine that the net profits and the commission payable to directors has been computed in terms of Schedule III to the Companies Act, 2013.

(h) He should ensure that the separate note have been given stating the computation of net profit under Section 198 of the Companies Act, 2013 with details of the commission payable as percentage of profits to the directors including Managing Directors/Manager (if any).

(i) He should also examine adherence to relevant sections of the Act, such as

- Section 309(3) and (4) which deals with manner of payment of managerial remuneration
- Section 309(2) which deals with the payment of sitting fees
- Section 198 which has prescribed overall limits to managerial remuneration

### B. Payment of Insurance Premium

***Documents to be Checked***

- Insurance policy
- Insurance premium receipts
- Demand letter
- Correspondences with the Insurance Company
- Related papers and vouchers

***Procedures followed/Duty of an Auditor***

(a) The auditor should examine both the insurance policy and the receipt received from the insurance company, if it is a new policy. For the old polices, only the receipt received may be examined.

(b) The auditor also examines the adequacy of insurance for the concern. The under-insurance or over-insurance should be checked periodically.

(c) He should ensure that premiums are not in arrears and the prepaid insurance has been properly adjusted against subsequent premium payable.

(d) He should confirm that the property belongs to the concern on which insurance premium has been paid.

(e) He should check that proper accounting treatment has been made for this.

**C. Payment of Dividend**

***Documents Required***

- Proposals of the shareholders or directors for payment of dividend
- Dividend register/book
- Counterfoils of dividend warrants
- Directors' or members' resolution
- Debenture trust deeds
- Bank passbook
- Memorandum of Association and Article of Association

***Procedures followed/Duty of an Auditor***

(a) The auditor should examine the internal control of the company regarding the payment of dividend.

(b) The auditor should verify the dividend paid with the counterfoil of dividend warrant.

(c) He should examine the Board's minutes regarding rate of dividend.

(d) He should check special provisions, if any, in the Memorandum and Articles of Association regarding payment of dividends.

(e) He should ensure that the provisions of the Companies (Declaration and Payment of Dividend) Rules, 2014 have been complied with in declaring dividends.

(f) Examine the company's procedure for payment of dividends including unclaimed dividends and ensure that they are not paid without adequate safeguard as to identification on the payee, checking of the payee's claims, etc.

(g) He should verify the shareholders' register and ensure that the names of all shareholders who are entitled to receive dividends have been included.

(h) Check the computation of dividends with reference to rate of dividends and number of shares held.

(i) See counterfoils of cheques for amount paid to shareholders.

(j) He should also examine, whether all the conditions for payment and source of dividend as specified under the Companies Act, 2013, have been complied with.

**5. What are the common features of Valid Vouchers?**

**Ans.** In general, a valid voucher should have the following features:

(a) *Amount* The amount written in the voucher must be the same as recorded in the books of account.

(b) *Serial Number* The vouchers should be serially numbered.

(c) *Date* The date of voucher must be the same with the date of transaction.

(d) *Client's Name* Voucher must contain the name of the organisation or the client.

(e) *Description of Transaction* Every voucher must contain the description of one transaction only.

(f) *Signature* Every voucher must be approved with signature by the higher authority.

(g) *Clarity* Voucher must be flawless. That is to say, hazy or incomplete writings must not be included in the voucher.

(h) *Permission for Correction* If there is any need to rectify or correct the voucher, then the permission of higher authority must be taken.

## CHAPTER 6 Verification and Valuation

**1. What do you mean by Contingent Liabilities? How is it disclosed in Financial Statements?**

**or**

**Define the term Contingent Liability. Give two examples of it.**

**Ans.** Contingent liability is

(a) a possible obligation that arises from past events and the existence of which will be formed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise,

or

(b) a present obligation that arises from past events but is not recognised because

(i) It is not probable that an outflow of resource embodying economic benefits will be required to settle the obligation, or

(ii) A reliable estimate of the amount of the obligation cannot be made.

As per above definition, to be called contingent liability, the following condition must be fulfilled:

(a) Possible obligation as a result of past event

(b) Existence of which will be confirmed only by the occurrence or non-occurrence of future event

(c) Future event not wholly within the control of the enterprise

**Examples of Contingent Liabilities are:**

(i) Disputed liability on account of income tax
(ii) Sales tax disputed
(iii) Discounting of bills receivables
(iv) Pending suits for damages or compensation
(v) Guarantees given by the bank on behalf of the company

**Disclosure of Contingent Liabilities**

Schedule III to the Companies Act, 2013 requires disclosure of the following liabilities/ commitments, to the extent not provided for, by way of a note:

**(i) Classification of Contingent Liabilities**

- Claims against the company not acknowledged as debts
- Guarantees
- Other money for which the company is contingently liable

**(ii) Classification of Commitments into**

- Estimated amount of contracts remaining to be executed on capital account and not provided for
- Uncalled liability on shares and other investments partly paid
- Other commitments (specifying nature)

**2. What do you mean by Verification and Valuation of assets? Do you think that Valuation is included in the task of Verification?**

**Ans. Verification** Verification of assets can be stated as a process of substantiation of assets recorded in the books of account, by means of physical inspection and examination of legal and official documents, and then forming expert opinion as to existence, ownership, possession, classification and valuation of assets of an entity.

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

**Valuation** Valuation of assets means the examination of the accuracy and propriety of the valuation of those assets, which are shown in the balance sheet of any concern at the end of the financial year. So, valuation is an operation, which includes:

(a) obtaining all the necessary information regarding valuation,
(b) analysing all the figures available,
(c) confirming the fact that the valuation is being determined on the basis of generally accepted conventions and accounting principles,

(d) ensuring the consistency of the methods followed for the valuation from year to year, and
(e) obtaining an opinion regarding the accuracy of valuation.

**Valuation is included in the Task of Verification** Verification means verifying the truth of the existence, values and ownership of the assets. Before signing his report, the auditor has to satisfy himself that the assets shown in the balance sheet really exist, they are in the name of his clients and the values shown are proper. The process of satisfying himself regarding all these points is 'verification'. Now the problem is what the correct value of an asset is. The assets would be deemed to be properly valued, if valuation is made according to the generally accepted accounting principles.

Valuation is concerned with the determination of value of the assets and liabilities of an entity at which it will be disclosed in the balance sheet. As a broader concept, verification includes the valuation part of assets and liabilities. So valuation of assets is a part and parcel of verification. Without proper valuation, the verification process cannot be completed.

While doing verification of assets the auditor will not only see the existence and ownership of assets but also ensure the sanctity and propriety of the amount at which they have been shown. He will confirm that assets have been valued on the basis of generally accepted accounting principles and a consistent basis of valuation is being followed year after year. So, verification has a broader perspective than valuation. It consists of valuation of assets and examination of existence and title of assets.

So, verification is dependent on valuation, which facilitates proper verification of assets and liabilities. Hence, it can be said that valuation is included in verification.

**3. How do you verify the following items?**

**(a) Goodwill or Investment**
**(b) Freehold Land**

**Ans. Goodwill** Goodwill arises from business connections, trade name or reputation of an enterprise. It may be generated either on acquisition or is internally generated. Internally generated goodwill is not to be recognised as an asset, as it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost. Goodwill should be recorded in the books, only when some consideration in money or money worth has been paid for it. The following issues to be taken into consideration while verification of Goodwill.

***Verification***

As it is not possible to verify goodwill physically, verification of goodwill means proper checking of accounting entries passed for it.

The following points are to be noted for verification of goodwill:

(a) Ensure that no goodwill is recorded, if no consideration has been paid. Goodwill has been recorded in the books only when some consideration in money or moneys has been paid for.
(b) Goodwill is equal to purchase consideration *less* fair value of net assets acquired. To verify this goodwill, the auditor should refer to vendor's agreement, minutes of the meetings of the Board of Directors, etc.
(c) See that goodwill has not been shown in the company's books by writing up the value of its assets, on revaluation, or by writing back the amount of goodwill earlier written off.
(d) Ensure that the goodwill not yet written off has been properly disclosed as per Schedule III requirements.
(e) See that the Goodwill is being amortised as per financial prudence over a reasonable period.

***Valuation***

(a) As per the current norms, goodwill should be written off over a ten-year period and be shown at cost less accumulated amortisation.
(b) The auditor should verify that goodwill appearing in the balance sheet has not been shown in excess of its cost price.
(c) In case a form is not earning above normal profits, the auditor should suggest for write it off.

**Investment** Investments are the assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing enterprise. An investment constitutes a significant portion of the total assets. An investment may be represented by government securities, shares, debentures, etc. For verifying and valuing of investments, the auditor should aim at collecting sufficient audit evidence in order to assure himself about the existence, ownership, valuation and possession of investment in favour of the client.

***Verification***

The following procedures should be adopted for verifying the investments:

(a) The auditor should examine whether the investments made are within the authority of the entity.
(b) He should obtain the investment register or schedule of securities containing the information of date of purchase, face value, book value, market value, rate of interest, date of payment of interest, date around which dividend is normally declared, etc.

(c) Securities and shares purchased and sold during the year should also be considered while doing the audit work.
(d) The balance of the register/schedule to be compared with the closing balance in the control account in the General Ledger for cross verification.
(e) The auditor himself should also be satisfied that the transactions for the purchase/sale of investments are supported by due authority and documentation.
(f) The acquisition/disposal of investments should be verified with reference to the brokers' contract note, bill of costs, etc.
(g) The auditor should verify the certificates corresponding to the investment physically on the last date of the accounting year.
(h) If the certificates are hold otherwise than in the name of the entity, the reasons must be justified.

***Valuation***

(a) For determining of cost of investments and classifying investments into long-term investments and current investments, the auditor should compare valuation practices against those prescribed by recognised accounting principles.
(b) Examine whether investments have been disclosed in balance sheet according to recognised accounting principles and relevant statutory requirements, if any.
(c) The auditor should examine whether in computing the cost of investment, the expenditure incurred on account of transfer fees, stamp duty, etc. is included in the cost of investments.

**Freehold Land** Freehold Land is the land which is 'free from hold' of any entity besides the owner. Hence, the owner of such a land enjoys free ownership for perpetuity and can use the land for any purpose in accordance with the local regulations.

***Verification***

The duties of an auditor in verifying freehold land is as under:

(a) Inspect the original title deed and conveyance or purchase deed which should be in the name of the owner.
(b) The auditor should obtain a certificate from the legal advisor of the client confirming the validity of the title to the property.
(c) He should also verify that the conveyance deed has been duly registered as required by the Indian Registration Act and the particulars to be endorsed thereon have been duly endorsed.
(d) If the land is mortgaged, the title deed would be in the possession of the mortgagee. A certificate to this effect should be obtained from the mortgagee or his lawyer.
(e) If any charge or encumbrances exist on land, the auditor should ensure that they have been properly disclosed.

*Valuation*

(a) Land is a non-depreciable asset. It is generally shown in the balance sheet at historical cost which includes purchase price, broker's commission, stamp duties, registration fees, legal charges and also leveling, clearing and draining charges.

(b) Where payments are made to the municipality for constructing sidewalks, laying of sewers, etc. such costs should, preferably, be shown separately in 'Land Improvement Account' and adequate depreciation should be provided for on it.

(c) If land and building were purchased as a package, the auditor should determine their values separately. For the said purpose, he should review documents such as appraisal report by valuers and tax assessment valuation report which can provide a basis for apportionment of costs between land and building.

**4. How do you verify the following items (any three)?**

**(a) Patent**

**(b) Contingent Assets**

**(c) Share Capital**

**(d) Plant and Machinery**

**Ans. Patent** A patent is an exclusive right granted by the Government to an inventor to manufacture and dispose of or otherwise benefit from the result of the invention of a production process. It is an official document, which secures to an investor exclusive right to make, use and sell his invention.

*Verification*

(a) The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent.

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

(c) The document of the patent should be physically verified by the auditor and it should be seen that it has been duly registered.

(d) The auditor should check the Patent Register in order to verify that it has been properly included therein.

(e) He has to verify that renewal fees have been paid on due dates by being charged to revenue and to the Patent Account.

(f) The last renewal receipt should be examined to ascertain that the patent has not lapsed.

(g) If a number of patents are held, a schedule thereof should be obtained.

*Valuation*

(a) The auditor should examine the patent to ensure that the company concerned is registered as the owner of the patent.
(b) The auditor should ensure that patents are being shown at cost less amortisation charges.
(c) Cost of patent is the acquisition cost, which may be purchase cost or invention cost. Also, the cost of registration of patent should be included in the valuation, while the renewal fees should be charged off to revenue.
(d) If the patent has been developed by the client in house, all development expenses, legal charges, including registration fees and other direct costs incurred in creating it, should be capitalised.
(e) The cost of patent should be written off over the legal term of its validity or over its useful commercial life, whichever is shorter.

**Contingent Assets** Contingent assets may be defined *"as an asset in which the possibility of an economic benefit depends solely upon future events that can't be controlled by the company."* Contingent assets are the possible assets that arise from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. Contingent assets should not be recognised – but should be disclosed where an inflow of economic benefits is probable.

*Verification*

(a) The auditor has to ensure that no contingent asset has been included in accounts.
(b) As regards valuation of contingent assets, it may be noted that ordinarily no valuation would be required. However, if such assets are disclosed by way of a note, a proper valuation based on the related contract would be made.
(c) The auditor should make a list of all future events that affect the future economic benefit. He should map potential economic benefits with all the future events. It can be a one-time payment or stream of payments.

**Share Capital** The audit of share capital is necessary both on incorporation and afterwards whenever the directors decide to increase the subscribed share capital. Section 2(50) of the Companies Act, 2013 defines Issued Capital which means such capital as the company issues from time to time for subscription. It is that part of authorised capital which is offered by the company for subscription. Schedule III of the Companies Act, 2013, makes it obligatory for a company to disclose its issued capital in the balance sheet. The verification processes of the 'Issued Capital' are as follows:

*Verification*

(a) Verify the amount of issued capital with reference to last year audited balance sheet. Also see whether the Central Government has issued any notification for conversion of debenture or loan into equity share under Section 62(4).

(b) Study the conditions of issue contained in the Memorandum and Articles of Association, Prospectus or statement in lieu of prospectus, shelf prospectus, red-herring prospectus and information memorandum, as the case may be, and see that all of them have fully been complied with.

(c) Verify that the first allotment was not made until the amount of minimum subscription stated in the Prospectus had been subscribed and until then the amount received was kept deposited in a scheduled bank as required by Section 39 of the Act.

(d) Confirm that the brokerage and underwriting commission was paid only at the rates authorised by the Prospectus or the Articles of Association, having regard to the provisions contained in Section 40 of the Act.

(e) Ensure that legal requirements as laid down in Section 62 (dealing with right shares) have been complied with.

(f) Ensure that the company intending to offer shares to the public for subscription by the issue of a Prospectus has, before such issue, made an application to one or more recognised stock exchanges for permission for the shared intending to be so offered within the stock exchange or each stock exchange as required by the Companies Act, 2013.

(g) Confirm that the guidelines issued by the Securities and Exchange Board of India (SEBI) have been followed. Compliance reports submitted by lead managers and reports submitted to SEBI may be examined in this regard.

(h) Verify compliance with legal provision relating to issue of shares at premium (Section 52), Prohibition on issue of shares at discount (Section 53), and issue of sweat equity shares (Section 54).

**Plant and Machinery** Plant and machinery contribute a major part in the tangible assets of the company. So the auditor should give proper attention while conducting verification of plant and machinery. The process of verification and valuation are as under:

***Verification***

(a) Inspect plant register which contains detailed particulars relating to various plants, machines and equipment along with their original cost, rate and amount of depreciation, accumulated depreciation, additions and sale from time to time.

(b) Prepare a statement from the Plant Register showing opening balance, sale and addition thereto during the year in respect of various items of machinery and plants. Its total is then reconciled with the balance in the General Ledger.

(c) Ensure that the management has physically verified the plant and machinery. The auditor should ask for the related working papers for his examination.

(d) In the absence of a Plant Register, the auditor should verify the register containing detailed particulars of various articles of machinery and equipment, showing separately original cost, addition to and sales from it from time to time.

(e) If there is any addition or disposals in the plant and machinery, it should be verified with the invoices, other incidental expenses, including installation expenses and other appropriate documents.

***Valuation***

(a) Plant and machinery should be valued at the cost of acquisition less depreciation.

(b) The auditor should check as to whether any of the items has been disposed of or sold during the year. In case of any sale, he should examine that it was properly authorised and the sale proceeds were credited to plant and machinery account. Any capital profit made should be transferred to capital reserve.

(c) In case any item or machinery has been scrapped, destroyed or sold, the auditor should ascertain that the profit or loss arising thereon has been correctly determined which has either been disclosed in the Statement of Profit and Loss or credited to the Capital Reserve.

(d) The auditor should confirm the existence of lien or floating charges, if any, by inspecting the Register of Charges.

(e) Verify that the plant and machinery has been properly shown under fixed assets in the balance sheet.

## CHAPTER 7 Company Audit

**1. Discuss the Qualifications of a Company Auditor.**

**Ans.** As per Section 141 of Companies Act, 2013, the following persons should be considered as qualified for this purpose:

(a) A person shall be eligible for appointment as an auditor of a company, only if he is a chartered accountant. [Section 141(1)]

(b) A firm can also be appointed by its firm name to be the auditor of a company, if majority of partners practicing in India are qualified for appointment as company auditor. [Section 141(1)]

(c) Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm. [Section 141(2)]

**2. Discuss the Disqualifications of a Company Auditor under Companies Act, 2013.**

**Ans**. As per Section 141(3), read with Rule 10 of Company (Audit and Auditor) Rule 2014, the following persons shall not be eligible for appointment as an auditor of a company:

(a) A body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who, or his relative or partner–

  (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company, of face value not exceeding rupees one lakh;

  (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh;

  (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees one lakh;

(e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;

(f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in Section 144.

Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor [Section 141(4)].

**3. 'An Auditor is an Agent of the Shareholders'. – Do you agree with the above statement? Justify your answer.**

**Ans.** The issue as to whether an auditor can be considered as an 'agent of the shareholders' or not, is debatable. There are conflicting opinions available in this regard.

**Arguments in Favour**

(a) Except in a few cases, where he is appointed by the BOD or by the Central Government, a company auditor is appointed by the shareholders at the AGM of the company. Moreover, even if he is appointed by others, a company auditor is required to protect the interest of the shareholders though his work and to submit the report to them. Hence, he may well be considered as the agent of the shareholders.

(b) In the case *Spackman* vs. *Evans* (1868), Hon'ble Justice Cranworth said 'The auditor may be the agent of the shareholders, so far as it relates to the audit of the accounts. For the purpose of the audit, the auditors will bind the shareholders'.

(c) As per Section 182 of the Law of Contract, an agent is a person who is appointed to work on behalf of an individual or an entity or to represent the individual or the entity to any third party. As per the decision of the case *H. Hedley Byrne Co*. vs. *Heller & Partners Ltd*. (1963), an auditor does have liability to third parties though in a few specified situations. Hence, a company auditor can surely be considered as the agent of the company.

**Arguments Against**

(a) As per Section 183 of the Indian Contract Act, a minor cannot appoint an agent. However, a minor can be a shareholder and accordingly may have direct role in appointing an auditor. Thus, the auditor cannot be an agent of the shareholders.

(b) As per Section 213 of the Indian Contract Act, an agent is required to submit accounts to his principal 'on demand'. However, an auditor does not submit any such accounts to the shareholders. Whether demanded or not, he only submits his report to the shareholders.

(c) As per Indian Contract Act, 'knowledge of the agent is the knowledge of the principal'. Accordingly, if an auditor is an agent of the shareholder, he is required to inform all information that he will gather during audit. However, in reality, an auditor is not legally bound to do so. His duty is only to report to the shareholders on the financial results and financial state of affairs of the company.

(d) As per Indian Contract Act, 'he who does by another, does by himself'. Hence, any act of the agent will be considered as the act of the principal. However, this is not true in case of auditors and shareholders. If an auditor distorts any fact in collusion with the directors, shareholders will never be held responsible for that act.

Based on the above arguments it may be concluded that an auditor is not an agent of the shareholders.

**4. Can Dividend be paid without writing off past losses?**

**Ans.** The issue of payment of dividend without making good past losses can be discussed based on the following three considerations.

**A. Judicial Pronouncements**

The legal decisions in this respect are as follows:

(a) *Ammonia Soda Co.* vs. *Arthur Chamberlain & Others (1918)* In this case, it was held that

(i) A company may declare dividend without making good the debit balance of Profit and Loss A/c.

(ii) After appropriate revaluation, if the value of fixed assets increases permanently, a company can adjust the debit balance of Profit and Loss A/c from that surplus and can pay dividend from current year's earnings.

(b) *Stapley* vs. *Read Bros. Ltd. (1924)* Here it was held that a company can write up at fair value an asset, which was written off excessively in the earlier years and utilise the sum for writing off the debit balance of Profit and Loss A/c and distribute the current profit as dividend. (However, the fixed asset referred in this context was the goodwill of the company). Thus, writing off past losses is not compulsory for payment of dividend.

**B. Provisions of Companies Act**

As per Section 123(1) of Companies Act 2013 as amended by Section 10 of the Companies (Amendment) Act, 2015, no company shall declare dividend unless carried over previous losses and depreciation not provided in previous year or years are set off against profit of the company for the current year. Therefore, as per this provision, no dividend can be paid without making good past losses.

**C. Prudent Business Outlook**

The debit balance of Profit and Loss A/c or the Statement of Profit and Loss is a clear indication that capital has eroded to such extent. Therefore, if the company decides to pay dividend out of current profits without making good such loss, it will fail to maintain its capital even in nominal terms. Further, it may also face the threat of extinction in the long run. Therefore, it will always be prudent for the company to set off all past losses before making any dividend payment out of current year's profit.

**5. Discuss the role of a Company Auditor regarding Depreciation.**

**Ans**. In respect of depreciation charged in the books of accounts of a company, the auditor is expected to perform the following duties:

(a) The auditor should examine that depreciation has been charged at the rates calculated based on the useful life and residual value of the asset as specified in Schedule II.

(b) The auditor shall also examine that the useful life or residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under an Act of Parliament or by the Central Government, has been applied in calculating the depreciation to be provided for such asset.

(c) The auditor shall verify whether the method of depreciation has been correctly disclosed in the accounts.

(d) He should also verify the disclosure regarding the useful life and residual value of the asset with proper explanation for considering higher useful life or scrap value.

(e) The auditor should examine whether depreciation has been accurately calculated on pro-rata basis on any addition, deletion, etc. made during the current year.

(f) He should also verify whether extra depreciation for the additional shifts have been duly provided for.

(g) Since no dividend can be paid out of profit without providing for depreciation, the auditor must see whether any such violation has been committed.

(h) The auditor also needs to verify that depreciation has been correctly accounted for.

(i) The auditor shall also verify whether the same method of depreciation has been followed over the years. If there appears any change in the method of depreciation, he must enquire the reason for such change and shall satisfy himself with the justification provided by the management. Moreover, the auditor shall also examine whether such a change has been appropriately accounted for.

(j) The auditor must also examine whether the depreciation charge is adequate or not. In case he is not satisfied with the amount of depreciation provided in the books of accounts, he shall ask the management to charge adequate depreciation on assets.

(k) Finally, the auditor shall also verify that the following information has been disclosed in the financial statements–

    (i) The original cost or any other value in substitute of original cost for each class of assets;

    (ii) Depreciation provided for each class of assets; and

    (iii) Accumulated depreciation for each class of assets.

## CHAPTER 8 Audit Report and Certificate

**1. What is Audit Report?**

**Ans.** In the words of Lancaster, "*A report is a statement of collected and considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of the subject matter of the report*."

An audit report is a document written in a standard format through which the auditor expresses his opinion regarding the reliability and correctness of an entity's financial statements. The preparation of audit report is the last work of audit. An auditor presents weaknesses, strengths and details of an organisation through the audit report.

**2. What are the different types of Audit Report?**

**Ans.** The audit report may be of two types: (1) Unqualified or clean audit report, and (2) Modified audit report.

An unqualified audit report, also known as "clean" audit report, is a report where the auditor opines that a client's financial statements are fairly presented in accordance with agreed upon criteria (e.g. GAAP). Such report is given when the auditor concludes that the financial statements give a "true and fair" view in accordance with the financial reporting framework. This type of report is issued by an auditor when the financial statements are free of material misstatements.

As per SA 705 "Modifications to the Opinion in the Independent Auditor's Report", modified audit report may be of the following types:

(a) Qualified audit report
(b) Adverse audit report
(c) Audit report with disclaimer of opinion
(d) Piecemeal audit report

**(a) Qualified Audit Report**

A qualified audit report is one which is submitted when the possible impact of the following on the financial statements is material, but not pervasive:

- Material misstatement in financial statements
- Inability on the part of the auditor to obtain sufficient audit evidence

A qualified audit report should **include the basis of qualified opinion**.

***Basis for Qualified Opinion***

Situations leading to a qualified opinion are:

- Non-adherence to AS-2 with regard to inventory valuation at the lower of cost and net realisable value
- Auditor being prevented by the management from observing the counting of physical inventory where such action is material to the financial statements

**(b) Adverse Audit Report**

An adverse audit report is one which is submitted when the possible impact of the following on the financial statements is material, but not pervasive:

- Material misstatement in financial statements

An adverse audit report should **include the basis of adverse opinion**.

***Basis for Adverse Opinion***

Situations leading to an adverse opinion are:

- Preparing the financial statements on going concern basis even after planning to cease the operation of the company within next six months.

**(c) Audit Report with Disclaimer of Opinion**

An audit report with a disclaimer of opinion is one which is submitted when the possible impact of the following on the financial statements is material, but not pervasive:

- Inability on the part of the auditor to obtain sufficient audit evidence

An audit report with a disclaimer of opinion should **include the basis for disclaimer**.

***Basis for Report with Disclaimer of Opinion***

Situations leading to reporting with a disclaimer of opinion are:

- Auditor being prevented by the management from (a) observing the counting of physical inventory and (b) performing other procedures such as requesting external confirmation of debtors and creditors, and bank account balances.

**(d) Piecemeal Audit Report**

When the auditor is not in a position to express his opinion about the entire financial statements of an entity due to the absence of information, he may decide to express an opinion about some of the items contained in the financial statements. Such opinion is called piecemeal opinion and the auditor's report containing such piecemeal opinion is called piecemeal report.

**3. Point out the essentials of a good Audit Report?**

**Ans.** The essentials of a good audit report are as follows:

(i) **Simplicity** A good audit report should be simple so that it can be easily understood by all. A good report is written in a simple language avoiding vague and unclear words. The message of a good report should be self-explanatory.

(ii) **Clarity** The report should be clear and unambiguous. Clarity depends on the proper arrangement of facts. The auditor should make his purpose clear, define his sources, state his findings and finally make necessary recommendations.

(iii) **Brevity** It should be concise, accurate and specific. It means that a good report is one that transmits maximum information with minimum words. It avoids unnecessary detail and includes everything which is relevant and required to present proper information.

(iv) **Firmness** It should clearly indicate the scope of work to be done. Further, the report should firmly state whether the financial statements of the entity reflect the "true and fair" view of the state of affairs of the business.

(v) **Objectivity** It should be based on objective evidence. Objective evidences facilitate comparison of financial statements with reliability and uniformity. It is very much required to reduce or eliminate biases, prejudices, or subjective evaluations by relying on verifiable data.

(vi) **Consistency** Consistency in presenting accounting information should be maintained in a good audit report according to GAAP or IFRS. It is essential for the auditor to verify whether the financial statements for the current period are consistent with the previous financial statements.

(vii) **Disclosure** It should disclose all facts and the truth. The auditor has to see whether relevant matters have been properly disclosed as per the regulatory or other requirements.

(viii) **Impartiality** It should be unbiased. If recommendations are made at the end of a report, they have to be impartial and objective.

(ix) **Information-based** Relevant and accurate information should be included in the report. If not so, it will involve unnecessary expenditure and the reports will be a waste. Since decisions are taken on the basis of information contained in the report, any inaccurate information or statistics will lead to wrong decision.

(x) **Timeliness** A report should be prepared and presented within the stipulated time. If the report is presented in time, necessary action may be taken.

**4. Write short note on Qualified and Unqualified Audit Report.**

**Ans. Qualified Audit Report** A qualified audit report is one which is submitted when the possible impact of the following on the financial statements are material but not pervasive:

- Material misstatement in financial statements
- Inability on the part of the auditor to obtain sufficient audit evidence

A qualified audit report should **include the basis of qualified opinion**.

***Basis for Qualified Opinion***

Situations leading to a qualified opinion are:

- Non-adherence to AS 2 with regard to inventory valuation at the lower of cost and net realisable value.
- Auditor being prevented by the management from observing the counting of physical inventory where such action is material to the financial statements.

**Unqualified Audit Report** An unqualified audit report, also known as "clean" audit report, is a report where the auditor opines that a client's financial statements are fairly presented in accordance with agreed upon criteria (e.g., GAAP). Such report is given when the auditor concludes that the financial statements give a "true and fair" view in accordance with the financial reporting framework. This type of report is issued by an auditor when the financial statements are free of material misstatements.

**5. State four important matters included in a Company Auditor's Report.**

**Ans.** As per SA 700 "Forming an Opinion and Reporting on Financial Statements", the basic elements of an audit report are as follows:

**(a) Title** In order to differentiate the audit report from other reports (such as the report of the Board of Directors), it is absolutely essential that the auditor's report has an appropriate title, i.e., "Auditor's Report".

**(b) Addressee** The Auditor's Report should be appropriately addressed as required by the circumstances of the engagement. Usually, the Auditor's Report is addressed to the appointing authority.

**(c) Introductory Paragraph** The introductory paragraph in the auditor's report shall:

(i) Identify the entity whose financial statements have been audited;

(ii) State that the financial statements have been audited;

(iii) Identify the title of each statement that comprises the financial statements;

(iv) Refer to the summary of significant accounting policies and other explanatory information; and

(v) Specify the date of and period covered by each statement comprising the financial statements.

**(d) Signature of the Auditor** The auditor has to sign the report in his personal name. When a firm is appointed as an auditor, the audit report has to be signed by the auditor in his personal name and in the name of the audit firm as well. The partner or proprietor signing the report has to mention the "Firm Registration Number" and the "Membership Number" assigned by the Institute of Chartered Accountants of India (ICAI).

**6. Is there any provision of the Companies Act to establish true and fair view of the Financial Statement of a Company? Also, mention four guiding factors to establish true and fair view of the Financial Statement.**

**Ans.** The Companies Act, 1913 used the term "true and correct". It was subsequently replaced by the term "true and fair" in the Companies Act, 1956. The term "fair" is a subjective term and it requires an exercise of judgement on the part of the auditor. There exist a huge debate and controversy over the use of the term "true and fair".

The term "true and fair" is an opinion and not a guarantee. It is the principle which is widely used in auditing and financial accounting. "True and fair view" in auditing means that the financial statements are free from material misstatements and faithfully represent the financial performance and position of the entity. The expression of true and fair view is, however, not strictly defined in the accounting literature, in the Companies Act or in a legal notion. As such, its interpretation leaves much room for flexibility. In general terms, "true" denotes that financial statements are factually correct and have been prepared according to the applicable reporting framework such as the IFRS and they do not contain any material misstatements that may mislead the users. On the other hand, "fair" implies that the financial statements present the information faithfully without any element of bias and they reflect the economic substance of transactions rather than just their legal form.

Preparation of true and fair financial statements has been expressly recognised as one of the responsibilities of the directors of companies in the corporate law of several countries such as in the Companies Act, 2006 in the UK. Company law of certain jurisdictions requires the auditors to expressly state in their audit report whether in their opinion the financial statements present a true and fair view of the financial performance and position of the entity.

According to Stettler Howard, fairness is a pervasive concept which extends to every phase of financial statement.

**Guiding Factors** The guiding factors of "true and fair view" are as follows:

(i) Material information has been properly disclosed.

(ii) In preparing the financial statements of an entity, generally accepted accounting principles have been strictly adhered to.

(iii) Financial statements of the entity have been prepared in accordance with regulatory requirements.

(iv) Disclosure of exceptional and non-recurring items have been properly made.

**7. What is Audit Certificate?**

**Ans.** An auditor's certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. It means that the person issuing or signing the certificate vouchsafes the truth of the statement made by him. According to Dicksee, a certificate is something that 'makes certain' and is thus, necessarily limited to facts capable of absolute verification. The scope of the audit certificate is limited. There is no scope of criticism, suggestions or recommendations in the audit certificate.

The audit certificate is objective as it is based on facts. It is a formal statement by the auditors which guarantee the accuracy of the accounts. It makes an auditor responsible, if anything stated in the certificate found as untrue later on.

**8. Distinguish between Audit Report and Audit Certificate.**

**Ans.** The main points of difference between audit report and audit certificate are presented below.

| Points of Difference | Audit Report | Audit Certificate |
|---|---|---|
| **1. Definition** | An audit report is a document written in a standard format through which the auditor expresses his opinion regarding the reliability and correctness of an entity's financial statements. | An auditor's certificate is a written confirmation of the accuracy of the facts stated therein. |
| **2. Nature** | It is an expression of opinion about an entity's financial statements. | It is a confirmation of correctness and accuracy about some matters. |
| **3. Scope** | The scope of the audit report is wide. | The scope of the audit certificate is limited. |
| **4. Criticism** | It may contain constructive criticism. | There is no scope of criticism in the audit certificate. |
| **5. Suggestion** | It may contain suggestions or recommendations of the auditor. | There is no scope of suggestions or recommendations in the audit certificate. |
| **6. Basis** | The audit report is based on facts, assumptions and estimations. | The audit certificate is based on actual figures and facts. |

(Contd.)

| | | |
|---|---|---|
| **7. Guarantee** | The audit report is actually an opinion by the auditors and does not guarantee the accuracy of the financial statements. | The audit certificate is a formal statement by the auditors which guarantee the accuracy of the accounts. |
| **8. Responsibility** | The audit report does not hold the auditor responsible for anything wrong in the financial statements. | The audit certificate makes the auditor responsible, if anything stated in the certificate found as untrue later on. |
| **9. Type/Feature** | The audit report is subjective since it is based on opinion. | The audit certificate is objective as it is based on facts. |
| **10. Format** | The audit report has to be presented in the prescribed format. | The audit certificate is not required to be presented in any standard format in most of the cases. |

**9. State the provisions of Companies Act regarding Contents of Audit Report.**

**Ans.** As per SA 700 "Forming an Opinion and Reporting on Financial Statements", the basic elements of an audit report are as follows:

**(a) Title** In order to differentiate the audit report from other reports (such as the report of the Board of Directors), it is absolutely essential that the auditor's report has an appropriate title, i.e., "Auditor's Report".

**(b) Addressee** The Auditor's Report should be appropriately addressed as required by the circumstances of the engagement. Usually, the Auditor's Report is addressed to the appointing authority.

**(c) Introductory Paragraph** The introductory paragraph in the auditor's report shall:

(i) Identify the entity whose financial statements have been audited;

(ii) State that the financial statements have been audited;

(iii) Identify the title of each statement that comprises the financial statements;

(iv) Refer to the summary of significant accounting policies and other explanatory information; and

(v) Specify the date of and period covered by each statement comprising the financial statements.

**(d) Management's Responsibility for the Financial Statements**

(i) In this section of the audit report, it is necessary to describe the responsibilities of those persons who are associated with the preparation of the financial statements of the organisation. However, the use of the word "management" is not mandatory. The audit report should use such term

that is appropriate in the context of the legal and regulatory framework applicable to the entity.

(ii) A section with the heading "Management's (or other appropriate terms) Responsibility for the Financial Statements" has to be included in the auditor's report.

(iii) The description of management's responsibility for preparation of the financial statements of the entity shall include an explanation that management is responsible for the preparation of the financial statements according to the applicable financial reporting framework. Further, this responsibility is inclusive of the design, implementation and maintenance of internal control relevant to the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.

(iv) Where the financial statements are prepared according to a fair presentation framework, the explanation of management's responsibility for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view", as appropriate in the circumstances.

**(e) Auditor's Responsibility** A section with the heading "Auditor's Responsibility" has to be included in the auditor's report. It shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit. Further, the auditor's report shall state that the audit was conducted in accordance with the "Standards on Auditing" (SA) issued by the Institute of Chartered Accountants of India (ICAI).

**(f) Auditor's Opinion** A section with the heading "Opinion" has to be included in the auditor's report. When expressing an unmodified opinion on the financial statements, the auditor's opinion shall state that the financial statements give a true and fair view.

**(g) Other Reporting Responsibilities** If the auditor addresses other reporting responsibilities in addition to the auditor's responsibility under the SAs, a separate section having the subtitle "Report on Other Legal and Regulatory Requirements" has to be included to incorporate those other reporting responsibilities.

**(h) Signature of the Auditor** The auditor has to sign the report in his personal name. When a firm is appointed as an auditor, the audit report has to be signed by the auditor in his personal name and in the name of the audit firm as well. The partner or proprietor signing the report has to mention the "Firm Registration

Number" and the "Membership Number" assigned by the Institute of Chartered Accountants of India (ICAI).

(i) **Date of the Auditor's Report** The date on which the auditor signs the report expressing his opinion on the financial statements of an entity is the date of the auditor's report.

(j) **Place of Signature** The auditor's report shall name the place of the specific location where the report is signed.

**10. Discuss the factors to be considered while judging materiality at the time of Audit of an Organisation.**

**Ans.** The concept of "materiality" implies that trivial matters are to be disregarded, and all important matters are to be disclosed. Materiality is the threshold or cut-off point above which missing or incorrect information in financial statements is considered to have an impact on the decision-making of users. As per SA 320 (Revised) "Materiality in Planning and Performing an Audit", misstatements, including omissions, are considered to be material if they, individually or in an aggregate, could reasonably be expected to influence the economic decisions of the users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances. What is material in one circumstance may be quite immaterial in another circumstance.

**Determining/Judging Materiality**

Materiality is a relative term. What may be material in one circumstance, may be immaterial in another. The consideration of materiality is the matter of professional judgement and experience of the auditor. There are no hard and fast rules that can be followed in all situations to determine materiality.

The following points have to be considered carefully in determining whether an item is material or not:

(a) **Nature of Transaction** The nature of the transaction is an important factor. For example, if a transaction of a small amount is occurring unusually, it may be material. But if it is a routine transaction, it may be immaterial.

(b) **Size or Amount of Transaction** The size or amount involved is another significant criterion. For instance, ₹ 1000 may be material to a small concern whereas it may be immaterial to a large concern.

(c) **Judging an Item Individually and in Aggregate** In judging materiality, an item should be considered separately as well as in aggregate. For example, an item may be immaterial separately, but it may be material when it is aggregated with many immaterial items. When this occurs, the effect becomes material.

**(d) Relative Significance** To judge the materiality of an item, its relative significance may be considered. If an item belongs to a group, it should be considered in relation to that group and not in isolation. For instance, a particular item of a current asset or current liability may be viewed on the basis of total current assets or total current liabilities.

**(e) Comparison with Previous Year's Figures** The materiality of an item can be considered by comparing it with the corresponding figure in the previous year. For example, if the amount of an item of the current year is very low or high while comparing it with the corresponding figure in the previous year, then it may become material when compared to the corresponding figure of the previous year.

**(f) Impact of Prior Period Items** In prior periods, misstatements may have been considered immaterial and may have been ignored accordingly. Such misstatements may affect the financial information of the current period.

**(g) Precise Calculation vs. Estimation** Even a small error is material, if such an error results from the amount of an item which has been determined precisely and objectively. But, if the amount of an item is subject to estimation, a minor difference from the estimate may be viewed as immaterial.

**(h) Deviation from Statutory Requirement** Deviation from regulatory requirement is often treated as material, even if the amount of deviation is minor.

## CHAPTER 9 Audit of Different Institutions

**1. Discuss the Internal Control Evaluation of Banks.**

**Ans.** The general scheme of internal controls in a bank is discussed below:

**(i) Division of Work and Rotation of Duties** The auditor should see the following in respect of division of work and rotation of duties:

(a) Every bank has a detailed policy on delegation of powers. The financial and administrative powers of each committee/each official/each position are communicated to all persons concerned. The auditor should examine whether the powers and authorities of various officers are well defined and commensurate with their status and responsibilities.

(b) The auditor should also check the work is so arranged that no transactions are complete unless the work of one person is checked by another.

(c) The auditor will check that employees are rotated from one duty to another duty without any prior intimation.

**(ii) Accounting Procedures** Internal control system in connection with accounting procedures is as follows:

(a) The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not. The auditor should evaluate the accounting procedures of banks to assess whether or not the ledgers and other books of accounts are kept up to date.

(b) The auditor may seek to identify the significant flow of the transactions and significant application systems that are relevant to the accounting process.

(c) The auditor should examine that the system of sanctioning loans and advances is in order and it safeguards the interest of banks.

**(iii) Maintaining Assets of Customers** The auditor should check that the ownership of shares, bonds and other financial assets taken as securities is transferred in the name of the bank and effective control of such securities is maintained. The auditor should see that assets like jewellery, certificates and other valuables are kept in joint custody of designated and responsible officers.

**2. Explain about Long Form Audit Report of a Bank.**

**Ans.** Long Form Audit Report (LFAR) is a separate report to be submitted to the management, in the prescribed format issued by the RBI. The latest format of LFAR has been revised in the year 2003 and was made effective from 31st March, 2003. The Guidance Notes on Audit of Banks issued by the Institute of Chartered Accountants of India deals with LFAR. The LFAR highlights certain important aspects of the working of the banks such as internal control system, accounting policies, profitability and financial position.

**(a) Internal Control System** The status of internal control system and procedure of banks have not been kept pace with the rapid expansion of branches and with the qualitative changes in the nature of business and risks of banks.

**(b) Accounting Policies** The accounting policies followed by banks, especially those relating to bad and doubtful advances, valuation of investments and other securities have changed significantly over the years. These aspects should be reflected in the LFAR.

**(c) Profitability** The auditor is expected to analyse variations in major items of income and expenditure and important ratios. He may comment on the extent of income generated through non-traditional and special activities and unusual items which had significantly impact on the profit/loss for the year of a bank.

**(d) Financial Position** The auditor after examining the books of accounts maintained by bank should draw a conclusion regarding the true and fair view of the financial statements.

**3. Write short notes on Non-Performing Assets.**

**Or**

**Explain with examples what is meant by Non-Performing Assets.**

**Ans. Non-Performing Assets** Advances of banks are classified into two categories, i.e., *standard* and *non-performing*. An advance which does not disclose any problems and does not carry more than the normal risk associated to the banking business is called a standard asset. A non-performing asset is also an advance other than a standard asset.

An asset, including a leased asset, becomes non-performing when it ceases to generate income for a bank.

Different kinds of credit facilities treated as performing or non-performing are discussed below:

**(a) Term Loans** A term loan is treated as a non-performing asset (NPA), if interest and/or installment of principal remain overdue for a period of more than *90 days*.

**(b) Cash Credits and Overdrafts** A cash credit or overdraft account is treated as NPA, if it remains *out of order* as indicated above.

**(c) Bills Purchased and Discounted** Bills purchased and discounted are treated as NPA, if they remain overdue and unpaid for a period of *more than 90 day*s.

**(d) Securitisation** The asset is to be treated as NPA, if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

**(e) Agricultural Advances** A loan granted for short duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for one crop season.

**(f) Credit Card Accounts** Credit card account will be treated as non-performing asset, if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the next statement date. The gap between two statements should not be more than a month. It is further suggested by RBI that banks should follow this uniform method of determining over-due status for credit card accounts while reporting to credit information companies and for the purpose of levying of penal charges, *viz.*, late payment charges, etc., if any.

**4. Discuss the different types of Non-Performing Assets.**

**Ans.** NPAs may be classified into Sub-standard, Doubtful and Loss assets.

**(a) Sub-standard Assets** Sub-standard assets are those assets which has remained NPA for a period of less than or equal to 12 months (with effect from 31st March, 2005). In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the bank in full.

**(b) Doubtful Assets** An asset would be classified as doubtful, if it has remained in the substandard category for a period of 12 months (with effect from 31st March, 2005). Doubtful assets has added characteristics besides the characteristics of sub-standard assets that the weaknesses make collection or liquidation in full – on the basis of currently known facts, conditions and values highly questionable and improbable.

**(c) Loss Assets** Loss assets are those assets which have been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off. As per the RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value."

**5. Discuss Provisions of Non-Performing Assets.**

**Ans.** A non-performing asset has a two-fold impact on the profitability of a bank. First, the bank ceases to earn income on this asset which is legitimate income and secondly, the bank is required to make provisions for these assets.

The banks should make provision against sub-standard assets, doubtful assets and loss assets as given below:

**(a) Loss Assets** Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.

**(b) Doubtful Assets**

(i) 100 per cent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.

(ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25 per cent to 100 per cent of the secured portion depending upon the period for which the asset has remained doubtful.

| Period for which the advance has remained in 'doubtful' category | Provision requirement (%) |
|---|---|
| Up to one year | 25 |
| One to three years | 40 |
| More than three years | 100 |

**(c) Sub-standard Assets** As per the RBI guidelines, a general provision of 15 per cent on total outstanding should be made without making any allowance for ECGC guarantee cover and **securities available**. The 'unsecured exposures' which are identified as 'sub-standard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent on the outstanding balance. However, in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts, which are classified as sub-standard, will attract a provisioning of 20 per cent instead of the aforesaid prescription of 25 per cent.

**6. Write short notes on Evaluation of Internal Control System of an Insurance Company.**

**Ans.** The statutory auditor should review the internal control of insurance companies in the following ways:

**(i) Underwriting** The main objective of an internal control system for underwriting is adherence to guidelines for acceptances of insurance, proper recording of insurance risk and its evaluation. The auditor should review the underwriting function which comprises of examination of applications for insurance, the rating of risks and the establishment of premiums.

**(ii) Premium** Premium is the consideration received by an insurer from the insured under an insurance contract. In this contract, insurer agrees to undertake certain sum of risk on behalf of the insured. The auditor should ensure that correct premium is calculated and collected before acceptance of any risk. Again the premium is accounted for in an appropriate manner and that the premium is collected only in respect of such risks which are assumed by the insurance company.

**(iii) Commission** The commission is the payable for getting the insurance business. The internal control in respect to commission is aimed at ensuring that commission is paid in accordance with the rules and regulations of the insurance company and as per the agreement with the agent.

**(iv) Reinsurance** The auditor will check reinsurance transactions which involve determination of correct amounts for reinsurance ceded, proper valuation of

assets and liabilities arising out of reinsurance transactions and adherence to legal provisions, regulations and reinsurance agreements.

**(v) Claims** Cost of claims includes all expenses incurred in settlement of claims. Auditor should ensure that only bonafide claims are paid. He will also check proper recording and disclosing of cost of claims in the financial statements.

**7. Mention the important points relevant for Audit of Insurance Companies.**

**Ans.** The following aspects are to be considered in case of audit of insurance companies:

**(i) Review of Internal Control** The auditor should review the internal control system in insurance companies to ensure its effectiveness.

**(ii) Receipts of Premium** The auditor should check the premium receipts with the insurance policies, cover notes, policy register, etc. Since premium is the main source of income of an insurance company, so it should be carefully checked with the necessary supporting documents.

**(iii) Verification of Cancelled Policies** The auditor should ensure that the policies against which no premium has been received, stands cancelled.

**(iv) Accounting Treatment of Premium** The auditor should see that proper adjustments have been made for outstanding premium, premium received in advance and ensure that the premium due on or before balance sheet date whether received or not have been properly accounted for.

**(v) Accounting Treatment of Claims** The auditor should ensure that claim account have been debited by proper amount, provisions for unsettled claims have been made, average clause have been applied for under insurance, provisions are less than amount of insurance, etc.

**(vi) Payment of Commissions** The auditor should see that commissions have been paid to agents as per rules and regulations and the treatment for outstanding commission has been properly made.

**(vii) Income from Investment** The auditor should see that income from investments have been properly accounted for. He should also see that year-end valuation of investment has been properly made.

**(viii) Remuneration of Employees** The auditor should see that employees' remuneration have been properly accounted for. He also ensures that reimbursement of other expenses has been debited against proper head.

**(ix) Management Expenses** The auditor should see that management expenses incurred have been authorised by the competent authority.

**(x) Interest and Bank Charges** The auditor should see that interest and bank charges have been properly accounted for.

**8. Prepare an Audit Programme of a Government College.**

**Ans.** Audit programme of a government college is discussed below:

**(i) Constitution** The auditor should go through the trust deed, regulations, Acts and statutes in respect of colleges and affiliating universities. Auditor must have knowledge about the different Acts, rules and regulations of concerned institutes as their provisions affect the accounts of the institute.

**(ii) Minutes Book** The auditor should carefully examine notices and minutes of the meeting of the Governing Body and other committees which affect the accounts and finance of the institute. He should confirm that the decisions taken are duly complied with for operation of bank accounts, approval of expenditure, etc.

**(iii) Budget** The auditor must check out the budget allocated on different heads and activities of the college.

**(iv) Verification of Transactions Related to Receipts** Auditor should do the following to verify transactions related to receipts:

(a) Collections of fees on different heads from students according to their classes and session must be verified with the cash book.

(b) Any arrear or old fees on account of fees, fines, etc. should be taken into consideration at the end of the each period.

(c) Advance fees received are also to be noted accordingly.

(d) Library fees or late fine imposed by the institutes should be recorded separately.

(e) Collections and payments made on account of students' hostel must be checked properly.

(f) Grants received from Government or other organisations should be checked properly.

(g) Donations received, if any, to be acknowledged and be recorded properly in the account.

(h) Rent received from the let out property, if any, be checked accordingly.

**(v) Verification of Transactions Related to Payments** The auditor should do the following to verify transactions relating to payments:

(a) Determine the operation of internal control system over the various heads expenditure.

(b) Check honorarium paid to the resource persons or external experts.

(c) Capital and revenue expenditure should be vouched separately.

(d) Caution deposit from the students to be refunded as per record in the register.

(e) Payment of various expenses should be verified with the proper vouchers.

(f) Purchase of fixed assets and IT related products must be checked physically.

(g) Allocation of fund for purchase of books and other library materials and its proper utilisation are required to be verified.

(h) Payment of salaries to the staff and wages for casual labour to be checked at the end of the year.

(i) Payment for hostel maintenance, if any, must be checked properly.

(j) Any financial aids given to the students should be examined.

**(vi) Employees Benefit Funds** The amount of Provident Fund received from the employees must be checked and verified.

**(vii) Maintenance of Different Registers** The auditor should ensure proper maintenance of stock registers, asset registers for furniture, stationeries, computers and other IT equipment, etc.

**(viii) Depreciation** The amount of depreciation charged on different fixed assets, books, etc. must be verified by the auditor.

**(ix) Taxation** The auditor should verify tax exemptions under Income Tax Act as well as TDS deductions from the salaries of the staff and deposit of the same with the proper authorities.

**(x) Financial Information** The auditor should verify the form and manner of presenting financial information comply with the account standards and applicable legal requirements.

**(xi) Certificates** Auditor should get appropriate representation of management and certificates with respect to various aspects covered during the audit.

**9. Describe in brief the Role of Comptroller and Auditor General (CAG).**

**Ans.** The Constitution of India and the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 prescribe duties and powers of the Comptroller and Auditor General (CAG) of India. So, the CAG of India plays an important constitutional role to maintain accounts and make audit of receipts and payments of the Central and State Governments. These are discussed below:

**(i) Compile Accounts of Union and States** The CAG to compile accounts of Union and States from the initial and subsidiary account rendered to the audit and accounts offices under his control. The CAG is responsible for the keeping of such accounts.

**(ii) Prepare and Submit Accounts to the President, Governors of States and Administrators of Union Territories having Legislative Assemblies** The CAG shall from the accounts compiled by him or by the Government or any other person responsible in that behalf, prepare accounts in each year. The accounts should reflect respective heads of the annual receipts and disbursements for the purpose of the Union, of each State and of each Union territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union territory having a Legislative Assembly.

**(iii) Provide Information and render Assistance to the Union and States** The CAG is responsible to provide information and render assistance in the preparation of their annual financial statements to the Union Government, to the State Governments or to the Governments of Union territories having Legislative Assemblies.

**(iv) General Provisions relating to Audit** The duties of the Comptroller and Auditor General in relation to audit are:

(a) to audit all expenditure from the Consolidated Fund of India and of each State and of each Union territory having a Legislative Assembly;

(b) to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(c) to audit all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(d) to audit all trading, manufacturing, profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State; and in each case to report on the expenditure, transactions or accounts so audited by him.

**(v) Audit of Receipts and Expenditure of Bodies or Authorities Substantially Financed from Union or State Revenues** Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union territory having a Legislative Assembly, the CAG shall audit all receipts and expenditure of that body or authority and report on the receipts and expenditure audited by him.

**(vi) Functions of Comptroller and Auditor General in the Case of Grants or Loans given to other Authorities or Bodies** Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the CAG shall scrutinise the

procedures by which the sanctioning authority satisfies itself as to the fulfilment of the conditions.

**(vii) Audit of Receipts of Union or of States** The CAG will audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union territory having a Legislative Assembly. He is to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.

**(viii) Audit of Government Companies and Corporations** The duties and powers of the CAG in relation to the audit of the accounts of Government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013.

**(ix) Audit of Accounts of Certain Authorities or Bodies** The audit of the accounts of anybody or authority has not been entrusted to the CAG by or under any law made by Parliament. He shall, if requested to do so by the President, or the Governor of a State or the Administrator of a Union territory having a Legislative Assembly, as the case may be, undertake the audit of the accounts of such body or authority on such terms and conditions as may be agreed upon between him and the concerned Government.

## CHAPTER 10 Audit Investigation

**1. What do you mean by Investigation?**

**Ans.** In the words of **Taylor and Perry**, investigation involves inquiry into facts behind the accounts, i.e., into the technical, financial and economic position of the business organisation. **Investigation is an in-depth examination of books and records for any special purpose**. Such examination may involve both financial and non-financial information.

Generally, an attempt made to find out the facts behind a particular situation, or to ascertain the truth is known as investigation. In the case of a business organisation, investigation refers to a planned, meticulous and critical examination of the books of accounts and transactions (both past and present) of an entity. The most common methods employed in the process of investigation are probing, examination, questioning, inquiry, inspection, etc.

**2. Explain the purposes of Investigation.**

**Ans.** The actual aim of conducting an investigation by an auditor on behalf of his client is to supply him the required information in the form of a report about the matter

specified. By and large, the purpose of an investigation is to collect, examine and appraise the facts in respect of desired field of activity for some special purpose as determined by the person on whose behalf the investigation is carried out. Nevertheless, the common objectives of an investigation are stated below:

(i) **Proposed Purchase of Business** Before purchasing a business, a client may appoint an investigator to examine the different aspects of the said business so that the investigator can give his views as to whether it will be prudent to go ahead with purchasing decision.

(ii) **Reasons for low Profitability** An investigator may be appointed to find out the causes of low profitability of a business and the ways to improve the same.

(iii) **Cause of high Employee Turnover** When the employees are frequently leaving an organisation, an investigator may be appointed to examine the causes of such high employee turnover so that appropriate measures can be taken to settle the issue.

(iv) **Proposed Investment in Particular Securities** Before investing in particular securities, a client may appoint an investigator to examine the worthiness of such investment.

(v) **Suspected Fraud** In case of any suspected fraud, an investigation may be conducted to identify the nature of fraud and the persons involved in the fraudulent activities.

(vi) **Joining in Existing Partnership Business** Before entering into a new partnership firm, a client may appoint an investigator to examine the profitability and solvency position of the firm, the reasons for admitting new partners, etc. in order to make sure that the decision as to entering into a new partnership firm does not backfire.

(vii) **Lending Funds** The lending institutions like banks, non-banking financial companies, etc. appoint investigator to judge the creditworthiness of the prospective borrower.

(viii) **Determining Sickness** In order to judge the nature and extent of sickness and the possibility of revival an investigation may be conducted.

(ix) **Settling Insurance Claim** An investigator may be appointed by a general insurance company to examine whether the claims submitted by the insured in relation to events like fire or other hazards are justified or not.

(x) **As per the Provisions of the Companies Act** Statutory investigation is required as per the provisions of Sections 210, 212, 213 and 216 of the Companies Act, 2013.

**(xi) Unusual Decline in Profit** An investigator may be appointed to find out the causes of unusual decline in profit so that appropriate action can be taken.

**(xii) For Business Combination** An investigator may be appointed for carrying out investigation work in relation to financial, technical, and administrative aspects of the concerned units.

**3. State the features of an Investigation.**

**Ans.** The main features of investigation are stated below:

**(i) Not Always Mandatory** Investigation is not always compulsory. It is often conducted on voluntary basis depending upon necessity. However, statutory investigation is required as per the provisions of Sections 210, 212, 213 and 216 of the Companies Act, 2013.

**(ii) Special Purpose** Investigation is an examination of books and records for any special purpose like to know the financial position, assess earning capacity, prove fraud, invest capital, etc.

**(iii) Time Horizon** Investigation may be conducted for several years at a time, say three years. In fact, the time horizon depends upon the requirement. There is no specific period for an investigation.

**(iv) Detailed Examination** Investigation is a thorough checking of the books of account for a particular or a number of years.

**(v) Scope** The scope of the investigation is generally limited since it attempts to answer only those questions that are asked in the engagement letter.

**(vi) Submission of Report** Investigation report is addressed to the party on whose instruction investigation was conducted.

**(vii) Flexibility** The investigator is free to design his plan of action as per the requirements of the concerned case. His design of plan is on the basis of his personal wisdom and judgement.

**(viii) Accountability** The investigator is accountable only to the person who appoints him for conducting investigation.

**4. Mention various types of Investigation with example.**

**Ans.** Investigation is of two types: (a) Non-statutory Investigation, and (b) Statutory Investigation.

**(i) Non-statutory Investigation** Non-statutory investigation may be of the following types:

(a) Investigation on behalf of an individual or a firm for the purchase of a business.

(b) Investigation in connection with the preparation of the report.

(c) Investigation on behalf of a bank or a Non Banking Financial Company (NBFC) or a lending institution for credit or lending purpose.

(d) Investigation on behalf of an individual or an institution intending to make investment in an organisation.

(e) Investigation for the detection of suspected or actual fraud.

(f) Investigation on behalf of an incoming partner who intends to join a partnership firm.

(g) Investigation by tax authority to ascertain the correct amount of tax liability.

(h) Investigation for the purpose of reviewing the profit forecast.

**(ii) Statutory Investigation** Statutory investigation is required as per the provisions of Sections 210, 212, 213 and 216 of the Companies Act, 2013. Investigation under the Companies Act, 2013 can be broadly divided into two categories:

(A) Investigation into the affairs of a company, and

(B) Investigation of ownership of a company.

**(A) Investigation into the Affairs of a Company** It can be further divided into three parts:

**(a) Investigation into the Affairs of a Company by an Inspector through an order of the Central Government (Section 210)**

The Central Government on forming opinion may order investigation:

- On receipt of the report of Registrar or Inspector under Section 208
- On intimation of special resolution passed by a Company
- In Public interest

The Central Government shall order investigation:

- On order passed by a Court; or
- The Tribunal

The Central Government may appoint one or more inspector to investigate into the affairs of the Company and report in the manner as directed by the Central Government.

**(b) Investigation into the Affairs of a Company by Serious Fraud Investigation Office (Section 212)**

The Central Government is empowered to order investigations by SFIO:

(i) On receipt of report of the Registrar/Inspector under Section 208

(ii) On intimation of special resolution passed by a Company

(iii) In Public interest

(iv) On request from any Department of the Central Government or State Government

Once an investigation is ordered by the Central Government for SFIO, no other investigating agency of the Central Government or any State Government shall proceed with investigation in such case in respect of any offence under this Act. Further, in case where any such investigation has already been initiated, it shall not be proceeded further with and the concerned agency shall transfer the relevant documents and records in respect of such offences under this Act to SFIO.

**(c) Investigation into the Affairs of a Company in other Cases (Section 213)**

The Tribunal may order investigation into the affairs of a company

- on applications by specified number of members
- on allegations of fraudulent activities of the Company or unlawful purposes or other matters specified under Section 213(b)

**(B) Investigation of Ownership of a Company** The Central Government is empowered to appoint inspectors to investigate and report on matters relating to Company and its membership to determine true persons:

- Who are or have been financially interested in the success or failure, real or apparent
- Who are or have been able to control or to materially influence the policy of the Company.

Such investigation may be ordered by the Central Government on orders by the Tribunal. The Central Government may define the scope of the investigation, define the period or limit investigation to matters with particular shares or debentures.

**5. How will you investigate Misappropriation of Cash?**

**Ans.** There is no one-size-fits-all procedure for detecting misappropriation of cash. It varies from one circumstance to another. However, the investigator may design his procedure of investigation in the following manner:

(i) Adequacy of the internal control system with respect to cash receipts and cash payments has to be verified.

(ii) Unusual items like unusual cash receipts or unusual old debtors' balance have to be examined carefully.

(iii) Vouchers in support of petty cash transactions have to be verified thoroughly. At the same time, checking has to be made as to whether such vouchers have approval from the competent authority.

(iv) Whether "teeming and lading" method has been applied or not has to be ascertained.

(v) The investigator has to examine whether there is any double payment or not.

(vi) Whether payment to creditors has been made by way of 'A/c Payee Cheque' or not has to be ascertained.

(vii) The investigator has to gather quotations from alternative sources with regard to some high value transactions to ascertain the propriety or justness of such transactions.

(viii) Whether discount has been allowed to the customers in accordance with the rules of the organisation or not has to be checked.

(ix) Entries of passbook and cash book have to be verified with the entries recorded in counterfoils of paying-in-slips.

(x) Whether debtors are making payment by way of 'A/c Payee Cheque' or not has to be ascertained.

**6. Make a brief outline of Investigation on Business Combination.**

**Ans.** In order to justify whether business combination between two or more organisations should be effected or not, an investigation may be carried out. Such investigation should have the following approach:

**(i) Examining the Background of the Companies** It is necessary to look into the background of the promoters of the concerned organisations which intend to be combined. By examining the previous history of the promoters, an idea about the possibility of clash of interest between them may be formed.

**(ii) Looking into Overall Situation** It is necessary on the part of the investigator to look into the matters like nature of business, production or manufacturing process, type and source of raw materials, existing market of the product or service, use of technology, employment condition, etc.

**(iii) Exploring the Possible Impact of Combination** The investigator has to study the possible impact of the proposed combination like

(a) Whether it will result in cost reduction

(b) Whether the effect of 'synergy' can be obtained

(c) Whether growth in topline and bottomline can be achieved

(d) Whether risk can be minimised

(e) Whether debt will be increased

(f) Whether the enhanced market share of the proposed combination can lead to low competition

**(iv) Examining the Statement of Profit and Loss** It is an important task on the part of the investigator to go through the statements of profit and loss of the entities in detail for the previous 5–10 years. While examining such statements the investigator should carefully look into the following:

(a) Whether proper allocation of expenditure between capital and revenue has been made

(b) Whether accounting policies have been strictly adhered to

(c) Whether adequate provision has been made for depreciation

**(v) Determining "Purchase Consideration"** After careful consideration of factors like intrinsic value, market value of shares and other significant factors, the investigator has to determine the amount of purchase consideration to be paid.

**(vi) Examining the Nature of Financing** The investigator has to carefully examine the nature of financing of the proposed combination, i.e., whether it will be all-cash settlement or settlement through exchange of shares or a combination of both. The impact of the proposed combination on the entity's earning per share (EPS), cost of capital, and liquidity has to be studied.

**(vii) Assessing the Impact on Management and Employee** The impact of the proposed combination on the management and employees has to be assessed thoroughly. The assessment should include the following:

(a) Whether the combination will make the employees redundant

(b) Whether the existing pay package will be adversely affected

(c) Whether the nature of job of the proposed combination will be suitable to retain all the managerial personnel.

**(viii) Assessing the Financial Stability of the Business** The investigator should assess the financial stability of the entities by examining carefully items like contingent liability, working capital, debt-equity position, etc.

**7. Distinguish between Auditing and Investigation.**

**Ans.** There exist substantial differences between audit and investigation. These differences are enumerated below.

| Points of Difference | Auditing | Investigation |
|---|---|---|
| **1. Legal binding** | Audit of annual financial statements is compulsory under the Companies Act, 2013. | Investigation is not compulsory in most cases under Companies Act, but voluntary depending upon necessity. |
| **2. Time Horizon** | Audit is conducted usually on annual basis. | Investigation may be conducted for several years at a time, say three years. In fact, the time horizon depends upon the requirement. There is no specific period prescribed for investigations. |
| **3. Object** | Audit is conducted to ascertain whether the financial statements show a true and fair view. | Investigation is conducted with a particular object in view, viz. to know financial position, earning capacity, prove fraud, invest capital, etc. |
| **4. Report submission** | Audit report is addressed to shareholders (or proprietors or partners). | Investigation report is addressed to the party on whose instruction the investigation was conducted. |
| **5. Person performing work** | Audit is to be conducted by a chartered accountant. | Investigation may be undertaken even by a non-chartered accountant. |
| **6. Parties for whom conducted** | Audit is conducted on behalf of shareholders (or proprietor, or partners). | Investigation is usually conducted on behalf of outsiders like prospective buyers, investors, lenders, etc. |
| **7. Checking Method** | In case of audit, test checks are applied. | Investigation is a thorough checking of the books of account for a particular or a number of years. |
| **8. Scope** | The scope of auditing is general, which attempts to give an opinion on the financial statement of the company. | The scope of the investigation is limited as it attempts to answer only those questions that are asked in the engagement letter. |
| **9. Nature of Evidence** | Audit is usually concerned with prima-facie evidence. | Investigation is usually concerned with conclusive evidence. |

**8. Outline the procedure to be adopted for Investigating the Sickness of an Organisation.**

**Ans.** In order to examine the nature and extent of sickness of an organisation, the investigator should adopt the following procedure:

**(i) Examining the Causes of Sickness** An organisation may be born sick or it may become sick with the passage of time. The reasons for sickness are plenty. Some reasons for sickness from the beginning are inappropriate site selection, choosing improper technology, selection of wrong product, etc. On the other hand, some reasons for subsequent sickness are managerial inefficiency, changes

in government policy, market constraints, etc. The investigator has to identify the causes of sickness and then he has to ascertain whether those causes are controllable or not.

**(ii) Judging the Extent or Degree of Sickness** The investigator has to determine the extent of sickness with the help of certain ratios like (i) Earnings before depreciation, interest and tax (EBDIT) to sales, (ii) EBDIT to total assets, (iii) Operating cash flow (OCF) to sales, (iv) OCF to total assets, etc. The ratios of the organisation have to be compared with the industry average or standard. Further, the investigator has to examine the financial statements to ascertain (i) whether allocation of expenditure has been properly made between capital and revenue, (ii) whether assets are properly valued or not, (iii) whether all liabilities are properly accounted for, (iv) whether fictitious sales have taken place, etc.

**(iii) Exploring the Revival Possibility** If the investigator is satisfied that the organisation has the potential to cut down operating loss gradually or it has the possibility to generate positive net worth in the near future, he can recommend the revival of the organisation. Such recommendations are usually made when the identified reasons for sickness are mostly controllable in nature.

**(iv) Suggesting Revival Measures** The investigator should suggest short-term as well as long-term measures for reviving the sick organisation. Short-term measures include (i) proper performance monitoring system, (ii) proper management of finance, (iii) measures for improving productivity, (iv) measures for enhancing capacity utilisation, (v) capital re-organisation scheme, etc.

Long-term revival measures are (i) use of modern and upgraded technology, (ii) designing product as per market demands, (iii) changing product-mix to match the taste of consumers, (iv) conducting surveys and market research.

Short-term measures relate to improving profitability and liquidity position of the concern whereas long-term revival measures are associated with the future development of the organisation. These measures require funding from various sources. As such, the investigator has to ascertain the proper sources of funding.

## CHAPTER 11 Other Thrust Areas

**1. What is Cost Audit? State its advantages.**

**Ans. Cost Audit** Cost Audit involves an examination of cost books, cost accounts, cost statements and subsidiary and prime documents with a view to satisfying the auditor that these represent true and fair view of the cost of production. This includes the examination of the appropriateness of Cost Accounting system.

The term 'cost audit' has been defined by the Institute of Cost Accountants of India as "Cost Audit is an independent examination of cost and other related information in respect of a product or group of products of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

**Advantages of Cost Audit** Cost audit is beneficial from the view point of management, society, shareholders and the government. The advantages are as under:

**A. To Management**

(i) **Reliable Data Source** Management will get reliable data for its day to day operations like price fixing, control decision making, etc.

(ii) **Check on Wastage** A close and continuous check on all wastages will be kept through a proper system of reporting to management.

(iii) **Corrective Actions** Inefficiencies in the working of the company will be brought to light to facilitate corrective action.

(iv) **Management by Exception** Management by exception becomes possible through allocation of responsibilities to individual managers.

(v) **Helps in Budgetary Control** The system of budgetary control and standard costing will be greatly facilitated.

(vi) **Valuation of Closing Stock** A reliable check on the valuation of closing stock and work in progress can be established.

(vii) **Detection of Errors and Frauds** It helps in the detection of errors and fraud.

**B. To Society**

(i) **Escape from Exploitation** Cost audit is often introduced for the purpose of fixation of prices. The prices so fixed are based on the correct costing data and so, the consumers are saved from exploitation.

(ii) **Controlling Price** Since price increase by some industries is not allowed without proper justification as to increase in the cost of production, inflation through price hikes can be controlled and consumers can maintain their standards of living.

**C. To Shareholders**

Cost audit ensures that proper records are kept as to purchases and utilisation of materials and expenses incurred on wages, etc. It also makes sure that the valuation of closing stocks and work in progress is on a fair basis. Thus, the shareholders are assured of a fair return on their investment.

**D. To Government**

(i) **Cost Plus Contract** Where the Government enters into a cost plus contract, cost audit helps government to fix the price of the contract at a reasonable level.

(ii) **Pricing for Essential Commodities** Cost audit helps in the fixation of ceiling prices of essential commodities and thus, undue profiteering is checked.

(iii) **Attention on Inefficient Units** Cost audit enables the government to focus its attention on inefficient units.

(iv) **Protection to Certain Industries** Cost audit enables the government to decide in favour of giving protection to certain industries.

(v) **Settlement of Trade Disputes** Cost audit facilitates settlement of trade disputes brought to the government.

(vi) **Creates a Healthy Competition** Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.

**2. What are the objectives of Cost Audit?**

**Ans.** Cost audit is the system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and documents of an organisation. Cost audit has both general and social objectives. The objectives are summarised below:

***General Objectives***

(i) **Detections of Errors and Frauds** Cost audit ensures that the prescribed procedures of cost accounting records rules are duly adhered to for detection of errors and fraud.

(ii) **Proper Maintenance and Compliance** It ensures verification of cost accounts with a view to ascertaining that these have been properly maintained and compiled according to the cost accounting system followed by the enterprise.

(iii) **Ascertainment of 'Cost Unit' and 'Cost Center'** It aims at proper maintenance and compliance verification of the cost of each 'cost unit' and 'cost center' to ensure that these have been properly ascertained.

(iv) **Inventory Valuation** It helps in inventory valuation.

(v) **Fixation of Price** It helps in facilitating the fixation of prices of goods and services.

(vi) **Reconciliation of Cost and Financial Accounts** Cost audit ensures periodical reconciliation between cost accounts and financial accounts.

(vii) **Optimum Utilisation of Resources** It also ensures optimum utilisation of human, physical and financial resources of the enterprise.

(viii) **Detection of Abnormal Loss** Cost audit also helps in detection and correction of abnormal loss of material and time.

(ix) **Cost Consciousness** Cost audit may be introduced to bring cost consciousness among the employees and management of the organisation

(x) **Inter Farm Comparison** It also aims at advising management, on the basis of inter-firm comparison of cost records, as regards the areas where performance calls for improvement.

(xi) **Promoting Corporate Governance** It promotes corporate governance through various operational disclosures to the directors.

(xii) **Accuracy of Costing Data** Cost audit ensures the accuracy of costing data is done by verifying the arithmetical accuracy of cost accounting entries in the books of accounts.

*Social Objectives*

(i) **Reasonable Price** Cost audit facilitates in fixation of reasonable prices of goods and services produced by the enterprise.

(ii) **Improvement in Productivity** It ensures improvement in productivity of human, physical and financial resources of the enterprise.

(iii) **Channelizing Resources** It helps in channelising the enterprise resources to most optimum, productive and profitable areas.

(iv) **Escalation Clause** It also ensures availability of audited cost data as regards contracts containing escalation clauses.

(v) **Settlement of Bill** It facilitates in settlement of bills in case of cost-plus contracts entered into by the Government.

(vi) **Findings the Areas of Inefficiency** It helps in pinpointing areas of inefficiency and mismanagement, if any, for the benefit of shareholders, consumers, etc., so that necessary corrective action could be taken in time.

**3. What is Management Audit? Discuss its advantages.**

**Ans.** Management audit is the unique process appraising the performance of directors, managers or in the other words, appraising the performance of the management. A working director is included as a manager for purposes of management audit. It is normally presumed to be a non-routine investigation into a performance of a manager or group of managers. But in a number of organisations, management audit is now a regular feature to examine and improve managerial effectiveness.

As per CIMA Terminology, "Management audit is an objective and independent appraisal of the effectiveness of the managers and effectiveness of the corporate structure in the achievement of company objectives and policies. Its aim is to identify existing and potential management weaknesses within an organisation and to recommend ways to rectify these weaknesses."

*Advantages of Management Audit*

Management audit is now becoming more popular everywhere. Almost all progressive organisations undertake voluntary management audit due to its advantages as under:

(i) **Framing Policies** It helps management in framing basic policies for the organisation and to define objectives.

(ii) **Preparing Plan** In pursuance of the objectives of the organisations, management audit helps in preparing a viable and achievable plan for the organisation.

(iii) **Implementing Plan** It helps in setting up an organisational framework to implement the plans.

(iv) **Designing System** It assists in designing systems and procedures for smooth operations of the organisation.

(v) **Reviewing MIS** It helps in designing and reviewing management information system (MIS) for decision making to help in coordination, motivation and control of the operations.

(vi) **SWOT Analysis** It assists in analysing SWOT (strengths, weaknesses, opportunities and threats) of the organisation and assists the organisation in stronger marketing.

(vii) **Help Government in Developing Country** In a developing country like India, management audit through CAG, Public Accounts Committee and Parliamentary Committee on Public Undertakings, has helped the Government in identifying improper or wasteful use of funds, checking extravagant organisational practices and curving ineffective use of physical resources.

(viii) **Monitoring Sick Industry** Indian financial institutions, banks and Board for Industrial Financial and Reconstruction (BIFR) have found management audit (called concurrent audit) useful in monitoring sick industrial units and to help those units in their rehabilitation.

(ix) **Cost Minimisation** The Railways of India have subjected their finances to open discussion by public to improve resource mobilisation, reduce cost of operations and conserve their scarce resources which are main objectives on management audit.

(x) **Social Cost Benefit Analysis** It can help in analysing social cost benefits for public projects like dams, power houses and national highways.

(xi) **Amalgamation and Merger** It is essential whenever a unit is planned to be taken over or an amalgamation or merger with other unit is proposed.

(xii) **Future Prospect** Growing number of professional managers, the continuing separation of ownership from management, the wider distribution of stockholders, increasing competition and sickness in industry will sooner or later make certified management audit compulsory just as financial audit has become statutory.

**4. Define Social Audit and state its objectives.**

**Ans.** The term 'Social Audit' has been defined as a process that allows any organisation to assess its social impact and ethical performance vis-à-vis its stated vision, mission and goals. It helps the organisation to set up measurement criteria for its social impact, account for its social performance, report on that performance and draw up action plans to improve that performance. The 'organisation' being discussed here could be a corporate body, government agency or any other agency whose actions or decisions have a social consequence.

As per *Calendonia Centre for Social Development, United Kingdom,* 'Social Auditing is a process that enables an organisation to assess and demonstrate its social, economic, and environmental benefits and limitations. It is a way of measuring the extent to which an organisation lives up to the shared values and objectives it has committed itself to. Social auditing provides an assessment of the impact of an organisation's non-financial objectives through systematically and regularly monitoring its performance and the views of its stakeholders.'

***Objectives of Social Auditing***

In order to measure and examine how far the business concerns have been able to discharge their social responsibility, that is, how much contribution has been made by the concern towards social welfare, the concept of 'social audit' was introduced in business arena. The broad objectives of any social audit engagement are as follows:

(i) **Meeting Social Objectives** Social auditing helps to assess the physical and financial gaps between needs and resources available to meet targeted social objectives.

(ii) **Creating Awareness** To create awareness among beneficiaries and providers of social and productive services.

(iii) **Development Programmes** Increasing efficacy and effectiveness of development programmes.

(iv) **Scrutiny of Policy** Scrutiny of various policy decisions, keeping in view stakeholders' interests and priorities, particularly of marginal sections of the society.

(v) **Estimation of Opportunity Cost** Estimation of the opportunity cost for stakeholders of not getting upon timely access to public services.

**(vi) Specific Objectives** The specific objectives of social audit engagements will, however, depend upon the context of audit.

**5. Discuss the Position of Social Audit in Indian Scenario.**

**Ans. Social Auditing in India**

Social auditing is more a new concept in India. Social auditing in India can be viewed from two aspects, i.e., social auditing in Government sector and social auditing in Corporate sector. These are discussed below:

**A. Government Scenario – CAG's Audit and Social Audit**

The Central and the State Government agencies institute several programmes from time to time under their development initiatives. These programmes need monitoring and evaluation systems to ensure that the resources that have been allocated are used in the right manner to yield the desired results. 73rd amendment to the Indian Constitution empowered the Gram Sabhas to conduct social audit. Right to Information Act, 2005 is also a key pillar of support for social audit system in India.

Comptroller and Auditor General of India (CAG) has conducted performance audits of most of the key socio-economic programmes of the Government of India, e.g., National Rural Employment Guarantee Scheme (NRGRES), National Rural Health Mission (NRHM), Sarva Shiksha Abhiyan (SSA), Mid-day Meals Scheme, Accelerated Rural Water Supply Programme (ARWSP) and Pradhan Mantry Gram Sadak Yojana (PMGSY).

CAG's performance audit procedures have some connotations (idea) of social auditing. However, the CAG audit procedures are designed more from the view point of the Government and the taxpayers and not from the view of the beneficiaries of the Government schemes. Social audit system seeks to fill this void.

The Task Group on Social Audit formed by the CAG of India envisages social audit initiatives in two levels. Firstly, social audits carried out by Gram Sabhas/ Panchayats or local level Vigilance and Monitoring Committees as stipulated by the Government in the guidelines of various social sector programmes and secondly, those carried out by civil society groups.

**B. Corporate Scenario**

So far as the corporate scenario of India is concerned, it is largely a voluntary action that has driven a large number of Indian corporates to publish details of their social accountability as part of their Annual Report. Corporates like ITC Ltd., Uniliver are some of the examples. Aditya Birla Group also discloses in its portal its plan and monitors its social projects.

The adoption of standards is the first step towards institutionalisation of Social Accounting. Irrespective of regulatory requirements, Indian corporates have a clear case to adopt voluntary Accounting and Reporting Standards on Social Performance to enhance their equity in the investor community. Indian corporate belonging to similar industries (that tend to have similar social and environmental impacts) can adopt common standards in these areas so that it is efficient and effective for social auditors to assess their performance using those standards. The corporate sector also has a specific role to play in the demand side of social auditing.

**6. Explain the concept of Auditor's Independence by pointing out Existing Provisions of Various Acts and Rules in support of it.**

**Ans.** There are two interlinked perspective of independence of auditors – independence of mind, and independence of appearance. The Code of Ethics for Professional Accountants issued by the International Federation of Accountants (IFAC) defines the term 'independence' as follows:

### "Independence' is

**(a)** **Independence of mind** – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and professional skepticism; and

**(b)** **Independence in appearance** – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's or a member of the assurance team's integrity, objectivity or professional skepticism had been compromised."

In all phases of his work, a chartered accountant is expected to be independent, but in particular, in his work as an auditor, independence has a special meaning and significance. Not only does the client but also the stakeholders, prospective investors, bankers and government agencies rely upon the accounts of an enterprise when they are audited by a chartered accountant. So, a chartered accountant is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work, such as his training and experience enables him to do so.

### Legal Measures for Ensuring Auditor's Independence

Auditor's independence is a vital issue for ensuring the fairness and reliability of the audit job. So, both of the Companies Act, 2013 and The Chartered Accountants Act, 1949 have specific provisions for ensuring auditor's independence. These are discussed below:

**A. The Companies Act, 2013**

The Companies Act, 2013 has enacted some specific provision for ensuring auditor's independence. These are as follows:

(i) The provisions disqualifying certain types of persons from undertaking audit in limited companies. [Section 141 (3)]

(ii) Provisions requiring resolution of members for appointing auditors in the annual general meeting. [Section 139(1)]

(iii) Provisions on appointment, re-appointment and removal of auditors, which aim at ensuring sufficient independence of auditor to carry out the audit in the larger interests of shareholders and others. [Section 139(1) & 140(4)]

(iv) Provisions relating to ceiling on the number of audits that can be undertaken by a Chartered Accountant. [Section 141(3)]

(v) Power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence. [Section 143(3)]

(vi) Establishment of an Audit Committee. [Section 177]

(vii) Appointment of Statutory Auditors in the government companies on the recommendation of the CAG. [Section 139(7)]

(viii) Appointment of Statutory Auditors in the public sector banks under the supervision of Reserve Bank of India. [Section 30(1) of Banking Regulation Act, 1949]

(ix) Establishment of Peer Review Board by the Institute of Chartered Accountants of India to evaluate the performance of audit firms.

(x) Statutory auditors are not allowed to undertake non-audit services. [Section 144]

(xi) As per Clause 139(2) of the Companies Act, 2013, in case of listed companies, an individual can be appointed as an auditor for only one term of five consecutive years. For an audit firm, the tenure of service is ten consecutive years.

(xii) Companies Act, 2013 also provides for constitution of National Financial Reporting Authority which will supervise the quality of audit service. [Section 132]

**B. The Chartered Accountants Act, 1949**

The Chartered Accountants Act, 1949 also includes provisions for ensuring auditor's independence. For example, a chartered accountant will be held guilty of professional misconduct:

(i) If he charges or offers to charge, accepts or offers to accept in respect of any professional employment, fees which are contingent upon the findings or results of

such employment, except in cases which are permitted under any regulations made under this Act.

[Clause 10 of Part I of First Schedule]

(ii) If he expresses his opinion about the financial statement of an enterprise in which he has a substantial interest unless he discloses the interest in his report.

[Clause (4) of Part-l of Second Schedule]

(iii) If he advertises for soliciting work or advertises in a manner which could be interpreted as soliciting or offering to undertake professional work.

[Clause (4) of Part-l of First Schedule]

# I
APPENDIX

# List of Companies Rules Issued in Pursuant with the Companies Act, 2013

In pursuant with the Companies Act, 2013, the Ministry of Corporate Affairs (MCA) has so far issued the following Rules.

- Companies (Specification of Definition Details) Rules, 2014
- Companies (Incorporation) Rules, 2014
- Companies (Prospectus and Allotment of Securities) Rules, 2014
- Companies (Share Capital and Debentures) Rules, 2014
- Companies (Acceptance of Deposits) Rules, 2014
- Companies (Registration of Charges) Rules, 2014
- Companies (Management and Administration) Rules, 2014
- Companies (Declaration and Payment of Dividend) Rules, 2014
- Companies (Accounts) Rules, 2014
- Companies (Audit and Auditors) Rules, 2014
- Companies (Appointment and Qualification of Directors) Rules, 2014
- Companies (Meetings of Board and its Powers) Rules, 2014
- Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014
- Companies (Inspection, Investigation and Inquiry) Rules, 2014
- Companies (Registration of Foreign Companies) Rules, 2014
- Nidhi Rules, 2014
- Companies (Adjudication of Penalties) Rules, 2014
- Companies (Miscellaneous) Rules, 2014
- Companies (Corporate Social Responsibility Policy) Rules, 2014

- Companies (Authorised to Registered) Rules, 2014
- Companies (Registration of Offices and Fees) Rules, 2014
- Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014
- Companies (Cost Records and Audit) Rules, 2014
- Companies (Filing of Documents and Forms in XBRL) Rules, 2014
- Companies (Mediation and Conciliation) Rules, 2014
- Companies (Indian Accounting Standards) (Amendment) Rules, 2015
- National Company Law Tribunal Rules, 2016
- NCLT (Procedure for Reduction of Share Capital of Companies) Rules, 2016
- Companies (Compromises, Arrangements and Amalgamations) Rules, 2016
- Companies (Transfer of Pending Proceedings) Rules, 2016
- Investor Education and Protection Fund Authority (Accounting, Audit, Transfer and Refund) Rules, 2016
- IEPF Authority (Recruitment, Salary and Other Terms and Conditions of Service Officers and Other Employees) Rules, 2016
- Investor Education and Protection Fund Authority (Appointment of Chairperson and Members, Holding of Meetings and Provision for Offices and Officers) Rules, 2016
- Companies (Removal of Names of Companies from the Register of Companies) Rules, 2016

**Note:** The above rules have been amended by the government from time-to-time.

II

APPENDIX

# List of Indian Accounting Standards (Ind AS)

The Ministry of Corporate Affairs (MCA) had notified the following accounting standards, known as Indian Accounting Standards (Ind AS) as Companies (Indian Accounting Standards) Rules, 2015 vide notification dated 16 February 2015 [*F. No. 01/01/2009/CL-V(Part)*].

Ind AS 101 – First-time Adoption of Indian Accounting Standards
Ind AS 102 – Share-based Payment
Ind AS 103 – Business Combinations
Ind AS 104 – Insurance Contracts
Ind AS 105 – Non-current Assets held for Sale and Discontinued Operations
Ind AS 106 – Exploration for and Evaluation of Mineral Resources
Ind AS 107 – Financial Instruments: Disclosures
Ind AS 108 – Operating Segments
Ind AS 109 – Financial Instruments
Ind AS 110 – Consolidated Financial Statements
Ind AS 111 – Joint Arrangements
Ind AS 112 – Disclosure of Interests in Other Entities
Ind AS 113 – Fair Value Measurement
Ind AS 114 – Regulatory Deferral Accounts
Ind AS 115 – Revenue from Contracts with Customers

Ind AS 1 – Presentation of Financial Statements
Ind AS 2 – Inventories
Ind AS 7 – Statement of Cash Flows
Ind AS 8 – Accounting Policies, Changes in Accounting Estimates and Errors
Ind AS 10 – Events after the Reporting Period
Ind AS 12 – Income Taxes
Ind AS 16 – Property, Plant and Equipment
Ind AS 17 – Leases
Ind AS 19 – Employee Benefits
Ind AS 20 – Accounting for Government Grants and Disclosure of Government Assistance
Ind AS 21 – The Effects of Changes in Foreign Exchange Rates
Ind AS 23 – Borrowing Costs
Ind AS 24 – Related Party Disclosures
Ind AS 27 – Separate Financial Statements
Ind AS 28 – Investments in Associates and Joint Ventures
Ind AS 29 – Financial Reporting in Hyperinflationary Economies
Ind AS 32 – Financial Instruments: Presentation
Ind AS 33 – Earnings per Share
Ind AS 34 – Interim Financial Reporting
Ind AS 36 – Impairment of Assets
Ind AS 37 – Provisions, Contingent Liabilities and Contingent Assets
Ind AS 38 – Intangible Assets
Ind AS 40 – Investment Property
Ind AS 41 – Agriculture

Subsequently, MCA has notified the Companies (Indian Accounting Standards) (Amendment) Rules, 2016 and introduced two new Indian Accounting Standards, viz., *Ind AS 11–Construction Contracts* and *Ind AS 18–Revenue*, and omitted *Ind AS 115–Revenue from Contracts with Customers.*

# 2017

# AUDITING — HONOURS

## First Paper

## (C – 21-A)

## Full Marks – 100

*The figures in the margin indicate full marks.*

*Candidates are required to give their answer in their own words as far as practicable.*

### Group – A

**1. What is Joint Audit? (4)**

**Ans.** Joint audit refers to the system of appointing more than one audit firm or individual chartered accountants to conduct the audit of a single organisation. Big companies with diversified activities are often found to appoint several chartered accountants to perform the statutory audit as joint auditors. This is because it ensures pooling together the resources and expertise of multiple auditors to perform the audit work efficiently and within a given time period which may otherwise not be possible for a single auditor.

or

**Can dividend be paid out of Capital Profit? (4)**

**Ans.** According to Section 123(1) of Companies Act, 2013, a company can declare or pay dividend for any financial year only –

(a) out of current year's profits after providing for depreciation; and/or

(b) out of the undistributed profits for any previous financial year or years after providing for depreciation; or

(c) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

It can be seen that in the above provisions, the term 'profit' has not been defined to include only the revenue profit. Therefore, capital profit should also be eligible for payment of dividend. However, in this respect, the following points should be given due consideration.

(i) As per Section 52 of the Act, capital profit arising out of issue of shares at a premium should be transferred to Securities Premium Account and should be used only for a few specified purposes mentioned in the Act. Thus, dividend cannot be paid out of it.

(ii) As per the Companies Act, 2013, profit on re-issue of forfeited shares is to be transferred to Capital Reserve. Hence, no dividend should be paid out of it.

(iii) No dividend can be paid out of any pre-incorporation profit as there is no existence of the company prior to its incorporation. So the company, in its capacity of a company cannot generate any profit from commercial operations prior to its incorporation.

**2. Explain Qualified Audit Report Mentioning two points of qualifications. (2+2)**

**Ans.** As per SA-705 "Modifications to the Opinion in the Independent Auditor's Report", a qualified audit report is one which is submitted when the possible impact of the following on the financial statements is material, but not pervasive:

- Material misstatement in financial statements
- Inability on the part of the auditor to obtain sufficient audit evidence

A qualified audit report should **include the basis of qualified opinion**. Two points of qualifications are:

- Non-adherence to AS-2 with regard to inventory valuation at the lower of cost and net realisable value.
- Auditor being prevented by the management from observing the counting of physical inventory where such action is material to the financial statements.

or

**Define the term 'True and Fair View'. (4)**

**Ans.** The expression 'True and Fair view' is not strictly defined in the accounting literature, in the Companies Act or in a legal notion. As such, its interpretation leaves much room for flexibility. In general terms, "true" denotes that financial statements are factually correct and have been prepared according to the applicable reporting framework such as the IFRS and they do not contain any material misstatements that may mislead the users. On the other hand, "fair" implies that the financial statements present the information faithfully without any element of bias and they reflect the economic substance of transactions rather than just their legal form. Therefore, the term "True and Fair View", in auditing, means that the financial statements are free from material misstatements and faithfully represent the financial performance and position of the entity.

**3. Name any four Standards on Auditing (SA) as prescribed by ICAI till date. (4)**

**Ans.** Four Standards on Auditing as prescribed by ICAI till date are as follows:

(a) SA-210 – Agreeing the Terms of Audit Engagements
(b) SA-300 – Planning an Audit of Financial Statements
(c) SA-520 – Analytical Procedures
(d) SA-530 – Audit Sampling

**4. What is meant by Auditing in Depth? (4)**

**Ans.** Auditing in depth refers to the procedure where a few selected transactions are meticulously examined from their beginning to their conclusion. In other words, it is a system which reviews each and every single aspect of a transaction during its execution as well as recording.

It is particularly helpful in case of large organisations where detailed examination of all records at every stage of a transaction is almost impossible. Hence, through this system the auditor selects a few representative transactions of material importance from a particular category and then conducts a detailed stage-by-stage examination. If no irregularity is found, the auditor may come to a conclusion that the entire category of transactions is likely to be free from any material irregularity.

or

**Define Analytical Procedure with the help of an example. (4)**

**Ans.** Analytical procedure may be defined as the process to carefully study the relationship between various financial and non-financial data, analysing their behaviour or pattern to identify any unusual deviation from the expected value of the item or any inconsistency with the relevant information and the reason thereof. According to SA-520 on 'Analytical Procedures', analytical procedure means evaluation of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

For example, the management of the entity may engage in a planned fraud by misappropriating cash through recording huge cash discounts against payments made by the customers. When the auditor will come across such huge discounts, he may conduct a trend analysis of such discount and may find that there is unusual increase in the same as compared against the earlier year and accordingly initiate substantive test to check every transaction to inspect the approval of discount by appropriate authority and also the reason for such approval.

**5. What is Audit File? State two items which are recorded in Permanent Audit File. (2+2)**

**Ans.** The file which is used by the auditor to preserve all the important documents relevant for the audit of an organisation is known as audit file. It basically acts as the archive of all the important statements, notes, etc. generated during the conduct of audit of the organisation.

According to SA-230, 'Audit Documentation', audit files are defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise of audit documentation for a specific engagement.

Two items which are recorded in Permanent Audit File are–

(a) Certified copies of audited accounts of the previous year.

(b) Extracts or certified copies of important legal documents, long-term agreements with third parties, etc.

## Group – B

**6. Distinguish between Auditor's Report and Certificate. (6)**

**Ans.** The main points of difference between audit report and audit certificate are presented below.

| Points of Difference | Audit Report | Audit Certificate |
|---|---|---|
| Definition | An audit report is a document written in a standard format through which the auditor expresses his opinion regarding the reliability and correctness of an entity's financial statements. | An audit certificate is a written confirmation of the accuracy of the facts stated therein. |
| Nature | It is an expression of opinion about an entity's financial statements. | It is a confirmation of correctness and accuracy about some matters. |
| Scope | The scope of the audit report is wide. | The scope of the audit certificate is limited. |
| Criticism | It may contain constructive criticism. | There is no scope for criticism in the audit certificate. |
| Suggestion | It may contain suggestions or recommendations of the auditor. | There is no scope for suggestions or recommendations in the audit certificate. |
| Basis | An audit report is based on facts, assumptions and estimations. | An audit certificate is based on actual figures and facts. |
| Guarantee | An audit report is actually an opinion by the auditors and does not guarantee the accuracy of the financial statements. | An audit certificate is a formal statement by the auditors which guarantee the accuracy of the accounts. |
| Responsibility | An audit report does not hold the auditor responsible for anything wrong in the financial statements. | An audit certificate makes the auditor responsible, if anything stated in the certificate found as untrue later on. |
| Type/Feature | An audit report is subjective since it is based on opinion. | An audit certificate is objective as it is based on facts. |
| Format | An audit report has to be presented in the prescribed format. | An audit certificate is not required to be presented in any standard format in most of the cases. |

or

**Discuss the factors to be considered while judging 'Materiality' at the time of preparing Audit Report. (6)**

**Ans.** The following factors have to be considered carefully in judging 'materiality' at the time of preparing the audit report:

- **(i) Nature of Transaction** The nature of the transaction is an important factor. For example, if a transaction of a small amount is occurring unusually, it may be material, but if it is a routine transaction, it may be immaterial.
- **(ii) Size or Amount of Transaction** The size or amount involved is another significant criterion. For instance, ₹1000 may be material to a small concern whereas it may be immaterial to a large concern.
- **(iii) Judging an Item Individually and in Aggregate** In judging materiality, an item should be considered separately as well as in aggregate. For example, an item may be immaterial when considered individually, but it becomes material, when it is aggregated with many immaterial items.
- **(iv) Relative Significance** To judge the materiality of an item, its relative significance may be considered. If an item belongs to a group, it should be considered in relation to that group and not in isolation. For instance, a particular item of a current asset or current liability may be viewed on the basis of total current assets or total current liabilities.
- **(v) Comparison with Previous Year's Figures** The materiality of an item can be considered by comparing it with the corresponding figure in the previous year. For example, if the amount of an item of the current year is very low or high while comparing it with the corresponding figure in the previous year, then it may become material.
- **(vi) Impact of Prior Period Items** In prior periods, misstatements may have been considered immaterial and ignored accordingly. Such misstatements may affect the financial information of the current period.
- **(vii) Precise Calculation vs. Estimation** A small error becomes material, if such an error results from the amount of an item which has been determined precisely and objectively. But, if the amount of an item is subject to estimation, a minor difference from the estimate may be viewed as immaterial.
- **(viii) Deviation from Statutory Requirement** Deviation from regulatory requirement is often treated as material even if the amount of deviation is minor.

**7. Discuss the different points to be considered by a Statutory Auditor before commencement of a new Audit.** **(6)**

**Ans.** The following points are to be considered by a statutory auditor before commencement of a new audit.

- **(a) Collection of Appointment Letter** At the very beginning, the auditor must collect a valid appointment letter from the client. The validity of the appointment letter is to be judged based on the statutory provisions governing the organisation.

**(b) Communication with the Previous Auditor** Before accepting appointment, the auditor must communicate with the previous auditor and enquire why he has not been reappointed.

**(c) Acceptance of Appointment** Being satisfied with the validity of appointment, the auditor should formally accept the appointment and inform the client about such acceptance. In case of a joint stock company, the statutory auditor must within 30 days of receiving the appointment letter, intimate the Registrar of Companies whether he has accepted the appointment or not.

**(d) Understanding the Nature and Scope of Audit Work** The auditor must form an understanding about the nature of the audit work based on different legal provisions in case of statutory audit.

**(e) Understanding the Nature of the Organisation** Before commencing audit, the auditor must collect information about the nature of the organisation, its history, list of products and services, its competitive position, general problems of the industry concerned, etc. to form an overall understanding of the firm.

**(f) Verification of Important Documents** In order to gain sufficient knowledge about the operation of the concern, the auditor will have to study all the important documents regarding its formation and operating policies. For example, in case of a joint stock company, the auditor must verify the Memorandum of Association, Article of Association, Prospectus, minutes of meetings, etc.

**(g) Study of Accounting System** After verifying the documents, the auditor must form an idea about the accounting system of the organisation he is going to audit. This is necessary as different organisations may have different accounting procedures and policies.

**(h) Collection of a Complete List of Books of Accounts** The auditor must also collect a complete list of books of accounts of the organisation and the names of all the personnel entrusted to maintain those books.

**(i) Checking Last Year's Final Accounts and Auditor's Report** In case of an existing organisation, the auditor will have to thoroughly study previous year's final accounts and the auditor's report thereon.

**(j) Requesting for Keeping Necessary Records, Lists etc. Ready** The auditors should also request the client to finalise the recording, casting and balancing of accounts, and to keep important lists, vouchers, statements, etc. ready for inspection.

**(k) Study the Soundness of Internal Control System** The auditor must also see whether there exists any internal control system in the organisation and, if so, how effective and reliable. This evaluation will help him to determine the extent of checking to be followed in the course of audit of various transactions.

**(l) Review the Work of Internal Auditor** In case the organisation has a separate internal audit department, the auditor should also assess the effectiveness of the same and, thereby, decide about the reliance to be placed on their reports. A well-functioning internal audit department can significantly reduce the burden of a statutory auditor.

**(m) Preparation of Audit Programme** After following the above steps, the auditor must finally prepare a well-planned and effective audit programme. The audit programme will clearly specify the extent of checking to be done and audit procedures to be used to obtain audit evidence along with a proper allocation of work based on the qualifications of the staff and time frame to complete such work.

**8. Define Management Audit. State its advantages. (2+4)**

**Ans.** Management audit is the unique process appraising the performance of directors, managers or in the other words, appraising the performance of the management. It is normally presumed to be a non-routine investigation into a performance of a manager or group of managers. But in a number of organisations, management audit is now a regular feature to examine and improve managerial effectiveness.

As per CIMA terminology, "Management audit is an objective and independent appraisal of the effectiveness of the managers and effectiveness of the corporate structure in the achievement of company objectives and policies. Its aim is to identify existing and potential management weaknesses within an organisation and to recommend ways to rectify these weaknesses."

***Advantages of Management Audit*** Management audit is now becoming more popular everywhere. Almost all progressive organisations undertake voluntary management audit due to its advantages as given below:

**(a) Framing Policies** It helps the management in framing basic policies for the organisation and defining the objectives.

**(b) Preparing Plan** In pursuance of the objectives of the organisations, management audit helps in preparing a viable and achievable plan for the organisation.

**(c) Implementing Plan** It helps in setting-up an organisational framework to implement the plans.

**(d) Designing System** It assists in designing systems and procedures for smooth operations of the organisation.

**(e) Reviewing MIS** It helps in designing and reviewing management information system (MIS) for decision-making in coordination, motivation and control of the operations.

**(f) SWOT Analysis** It assists in analysing SWOT (strengths, weaknesses, opportunities and threats) of the organisation and helps in marketing the organisation stronger.

(g) **Help Government in Developing Country** In a developing country like India, management audit through CAG, Public Accounts Committee and Parliamentary Committee on Public Undertakings, has helped the Government in identifying improper or wasteful use of funds, checking extravagant organisational practices and curving ineffective use of physical resources.

(h) **Monitoring Sick Industry** Indian financial institutions, banks and Board for Industrial Financial and Reconstruction (BIFR) have found management audit (called concurrent audit) useful in monitoring sick industrial units and to help those units in their rehabilitation.

(i) **Cost Minimisation** Management audit also helps in minimising the cost by locating the areas of inefficiencies and, thereby, suggesting the management to take corrective actions.

(j) **Social Cost Benefit Analysis** It can help in conducting social-cost benefit analyses for public projects like dams, power houses, and national highways.

(k) **Amalgamation and Merger** It is essential whenever a unit is planned to be taken over or an amalgamation or merger with other unit is proposed.

(l) **Future Prospect** Growing number of professional managers, continuing separation of ownership from management, wider distribution of stockholders, increasing competition and sickness in industry will sooner or later make the certified management audit compulsory just as the financial audit that has become statutory.

or

**Write a short note on 'Auditor's Independence' with special reference to the provisions of the Companies Act and SA, if any.** **(6)**

**Ans.** In all phases of a chartered accountant's work, he is expected to be independent, but in particular in his work as an auditor, independence has a special meaning and significance. Not only does the client but also the stakeholders, prospective investors, bankers and government agencies rely upon the accounts of an enterprise when they are audited by a chartered accountant. So, a chartered accountant is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work such as his training and experience enables him to do so.

Auditor's independence is a vital issue for ensuring the fairness and reliability of the audit job. So, both of The Companies Act, 2013 and The Chartered Accountants Act, 1949 have specific provisions for ensuring auditor's independence. These are discussed below:

**Provision of the Companies Act, 2013 regarding Auditor's Independence** **(6)**

The Companies Act, 2013 has enacted some specific provision for ensuring auditor's independence. These are as follows:

(i) The provisions disqualifying certain types of persons from undertaking audit in limited companies. [Section 141 (3)]

(ii) Provisions requiring resolution of members for appointing auditors in the annual general meeting. [Section 139(1)]

(iii) Provisions on appointment, re-appointment and removal of auditors, which aim at ensuring sufficient independence of auditor to carry out the audit in the larger interests of shareholders and others. [Section 139(1) & 140(4)]

(iv) Provisions relating to ceiling on the number of audits that can be undertaken by a chartered accountant. [Section 141(3)]

(v) Power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence. [Section 143(3)]

(vi) Establishment of an Audit Committee. [Section 177]

(vii) Appointment of Statutory Auditors in the government companies on the recommendation of the CAG. [Section 139(7)]

(viii) Establishment of Peer Review Board by the Institute of Chartered Accountants of India to evaluate the performance of audit firms.

(ix) Statutory auditors are not allowed to undertake non-audit services. [Section 144]

(x) As per Section 139(2) of the Companies Act, 2013, in case of listed companies, an individual can be appointed as an auditor for only one term of five consecutive years. For an audit firm, the tenure of service is ten consecutive years.

(xi) Companies Act, 2013 also provides for constitution of National Financial Reporting Authority which will supervise the quality of audit service. [Section 132]

**Provision of Standards on Auditing (SA) on Auditor's Independence**

There are some specific provisions in the Standard on Auditing (SA) issued by the Institute of Chartered Accountants of India (ICAI). These SAs are summarised below:

| Sl. No. | No. of Standard | Title of the Standard |
|---|---|---|
| **1.** | SA-200 | Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing |
| **2.** | SA-705 | Modifications to the Opinion in the Independent Auditor's Report |
| **3.** | SA-706 | Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report |
| **4.** | SRE-2410 | Review of Interim Financial Information Performed by the Independent Auditor of the Entity |

**9. Discuss any four types of sampling used in Auditing.** **(6)**

**Ans.** There are several methods that fulfil this basic objective of sampling in an auditing exercise. Four of these methods/types are discussed below:

**(a) Random Sampling** In this method of sampling, each item of the population or within a given group (popularly known as stratum) has a known chance of selection. Random sampling can again be of two types –

  **(i) Simple Random Sampling** Under this method of sampling, each unit of the population has an equal chance of being selected in the sample. Here, selection is normally done either by choosing a random number manually from a random number table or allowing the computer program to select a random number and then identifying the population unit that corresponds to the random number by using any predefined rule.

  **(ii) Stratified Sampling** This method requires a given heterogeneous population to be first divided into a number of sub-populations (known as stratum) with homogeneous items and then selecting equal or unequal proportion of items from each group to form a representative sample of reasonable size.

**(b) Systematic/Interval Sampling** This method requires selecting items using a constant interval between selections with the first selection being random. The interval can be based on a number (like every 30$^{th}$ item in the list) or a monetary value (like ₹ 30,000 of cumulative value of after the last selection). Though this method seems very easy, the auditor must ensure that the population is not structured in a manner that the interval always corresponds to any pattern in the population. Systematic sampling can again be of two types namely Block Sampling and Cluster Sampling.

**(c) Multi-stage Sampling** This method is suitable when data is stored in more than one level. For example, an organisation may have stock stored at a number of shops. Here, the first step would be to randomly select a few shops and then to randomly select a few stock items from the shops already selected. If applied cautiously, this method proves to be very effective.

**(d) Haphazard Sampling** Under this method, the auditor selects items without following any predetermined or structured rule. However, the auditor must avoid any conscious bias or predictability while making such selection (such as selecting only odd numbered vouchers, entries in the first and last pages, etc.). Haphazard sampling is appropriate only for non-statistical or judgemental sampling.

or

**Write in brief different stages in Sampling.**

**Ans.** Audit sampling requires the following steps.

**(a) Sample Design** At this stage, the auditor should carefully consider the objectives of sampling and the nature of the population units. Based on this consideration, he must

finalise the sampling method. For example, if population units are mostly homogeneous, simple random sampling may be adopted.

**(b) Sample Size Determination** Sample size should be so determined that it would minimise the sampling risk. Sample size can be determined by the application of a statistics based formula or by professional judgment of the auditor.

**(c) Sample Selection** Sample units should be so selected that each sample becomes a representative of the population concerned and bias, if any, is avoided.

**(d) Performing Audit Procedures** The auditor, then, perform the audit procedure on each item selected. If the procedure is not applicable on a selected item, it should be performed on a replacement item. If the auditor is unable to apply the procedure at all, it will be considered as a deviation from the prescribed control (in case of test of control) or a misstatement in case of a test of details.

**(e) Nature and Cause of Misstatements** The auditor shall identify the nature and cause of misstatement to evaluate its possible impact on the purpose of auditing. The auditor must be least assured whether or not such misstatement is representative of the population.

**(f) Projecting Misstatements** In case of test of details (i.e. vouching and verification), the auditor must project misstatements found in the sample to the population. However, for test of control (i.e., testing the effectiveness of internal control), no explicit projection is required.

**(g) Evaluating the Results of Audit Sampling** Evaluation of the results may raise the following situations:

(i) In case of test of control, a high degree of sample deviation will lead to an increase in the assessed risk of material misstatements.

(ii) In case of test of details, an unexpectedly high misstatement amount will mean that a class of transaction or account balance is materially misstated. In such a situation, if the projected misstatement is higher than the tolerable misstatement, the auditor will conclude that the sample does not provide a reasonable basis for the population tested.

(iii) In the above case, the auditor will either ask the management to investigate the misstatements identified as well as the potential misstatements, if any, and to undertake necessary adjustments; or modify the nature, timing and extent of those audit procedures to achieve better results. For example, the auditor may increase the sample size or test an alternative control.

**10. Distinguish between Audit and Investigation. (6)**

**Ans.** There exist substantial differences between audit and investigation. These differences are enumerated below.

| Points of Difference | Auditing | Investigation |
|---|---|---|
| **Legal binding** | Audit of annual financial statements is compulsory under the Companies Act, 2013. | Investigation is not compulsory in most cases under Companies Act but voluntary depending upon necessity. |
| **Time horizon** | Audit is conducted usually on annual basis. | Investigation may be conducted for several years at a time, say three years. In fact, the time horizon depends upon the requirement. There is no specific period. |
| **Object** | Audit is conducted to ascertain whether the financial statements show a true and fair view. | Investigation is conducted with a particular object in view, viz., to know financial position, earning capacity, prove fraud, invest capital, etc. |
| **Report submission** | Audit report is addressed to shareholders (or proprietors or partners). | Investigation report is addressed to the party on whose instruction investigation was conducted. |
| **Person performing work** | Audit is to be conducted by a chartered accountant. | Investigation may be undertaken even by a non-chartered accountant. |
| **Parties for whom conducted** | Audit is conducted on behalf of shareholders (or proprietor, or partners). | Investigation is usually conducted on behalf of outsiders like prospective buyers, investors, lenders, etc. |
| **Checking method** | In case of audit, test checks are applied. | Investigation is a thorough checking of the books of account for a particular or number of years. |
| **Scope** | The scope of auditing is general, which attempts to give an opinion on the financial statement of the company. | The scope of the investigation is limited as it attempts to answer only those questions that are asked in the engagement letter. |
| **Nature of evidence** | Audit is usually concerned with prima-facie evidence. | Investigation is usually concerned with conclusive evidence. |

## Group – C

**11. Discuss the provisions of Companies Act, 2013 in respect of removal of an Auditor. (10)**

**Ans.** A company auditor can be removed from his office in the following ways:

A. **Removal of Auditor before the Expiry of His Term** The auditor appointed under Section 139 may be removed from his office before the expiry of his term subject to the fulfilment of the following conditions under Section 140(1) read with Rule 7 of CAAR 2014.

(a) An application to the Central Government for removal of the auditor shall be made in Form **ADT-2.** The application shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

(b) The application shall be made to the Central Government within thirty days of the resolution passed by the Board.

(c) The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution for removal of the said auditor.

(d) The auditor concerned shall be given a reasonable opportunity of being heard.

**B. Removal of the Auditor by Tribunal** The provisions in relation to removal of an auditor as contained in Section 140(5) are as follows:

(a) The Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, may, by order, direct the company to change its auditors, if it is satisfied that the auditor has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers.

(b) If the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall, within fifteen days of receipt of such application, make an order to removal the auditor from his office.

(c) The Central Government may appoint another auditor in his place.

(d) An auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under Section 447.

In addition to the above provisions, any auditor can be removed in the following circumstances as mentioned in the Chartered Accountants Act, 1949.

(a) If the auditor does not communicate with the previous auditor before accepting his appointment in place of the previous auditor.

(b) If any chartered accountant neglects his professional duties.

(c) If any chartered accountant starts any venture or is appointed elsewhere, other than the accounting profession, without any prior approval of the Council of Chartered Accountants in India.

(d) If any chartered accountant violates any provision of the Chartered Accountants Act.

or

**What is Unclaimed Dividend? Discuss the provisions of Companies Act, 2013 regarding Unclaimed Dividend.** **(10)**

**Ans.** In some situations, the company may find that some of the shareholders are untraceable. This is because either they have not updated their current corresponding address or perhaps the respective shareholder has died and his/her legal heirs have not applied for change in ownership. As a result, the dividend payable to the shareholder will remain unclaimed. This is known as unclaimed dividend. This is also known as unpaid dividend.

The Companies Act, 2013 contains the following provisions in respect of unpaid/unclaimed dividend.

1. **Transfer of Unpaid Dividend to Separate Account [Section 124(1)]**
   (a) Where a dividend has been declared by a company but has not been paid to or claimed by any shareholder within thirty days from the date of the declaration of the dividend, the company shall transfer the total amount of unpaid dividend to a special account.
   (b) The transfer shall be made within seven days from the date of expiry of the said period of thirty days.
   (c) The special account, for this purpose, shall be opened by the company in any scheduled bank and will be named as Unpaid Dividend Account.
2. **Details of Unpaid Dividend to be Published in the Website [Section 124(2)]** Within a period of ninety days of making any transfer of an amount to the Unpaid Dividend Account, the company shall, prepare a statement containing the names, their last known addresses and the unpaid dividend to be paid to each person and place it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose.
3. **Interest to be Paid by the Company in Case of Default [Section 124(3)]** If the company fails to transfer the total amount of unpaid dividend or any part thereof to the Unpaid Dividend Account of the company, it shall pay an interest at the rate of twelve per cent per annum on the amount that has not been transferred to the said account from the date of such default. Such interest will be distributed among the respective shareholders to whom the dividend is unpaid in proportion to the amount remaining unpaid to them.
4. **Payment out of Unpaid Dividend Account [Section 124(4)]** Any person claiming to be entitled to any money transferred to the Unpaid Dividend Account of the company, may apply to the company for payment of the money claimed.
5. **Transfer to Investor Education and Protection Fund [ Section 124(5)]** If any money transferred to the Unpaid Dividend Account remains unpaid or unclaimed for a period of seven years from the date of such transfer, it shall be transferred by the company

along with interest accrued, if any, thereon to the Investor Education and Protection Fund (IEPF) established by the Central Government u/s 125(1).

6. **Details of Transfer [Section 124(5)]** The company shall send a statement in the prescribed form of the details of such transfer to the authority which administers the said fund and that authority shall issue a receipt to the company as evidence of such transfer.
7. **Obtaining Receipt of Transfer [Section 124(5)]** The company shall obtain a receipt from the authority of the IEPF as evidence of such transfer.
8. **Transfer of Shares [Section 124(6)]** All shares in respect of which dividend has not been paid or claimed for seven consecutive years or more shall be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing the details of such transfer in the prescribed format. However, the claimant of shares transferred above shall be entitled to claim the transfer of shares from Investor Education and Protection Fund in accordance with such procedure and on submission of such documents as may be prescribed. Further, in case any dividend is paid or claimed for any year during the said period of seven consecutive years, the share shall not be transferred to Investor Education and Protection Fund.
9. **Penalty for Non-compliance [Section 124(7)]** If a company fails to comply with any of the requirements of Section 124, the company shall be punishable with a fine of minimum five lakh rupees and maximum twenty-five lakh rupees. Moreover, every officer of the company who is in default shall be punishable with fine of minimum one lakh rupees and maximum five lakh rupees.
10. **Refund of Unclaimed Dividend from IEPF [Section 125]** Any person claiming to be entitled to any unclaimed dividend may apply to the authority of IEPF constituted under Section 125(*5*) for the payment of the money claimed.

**12. (a) Prepare an Audit Programme in respect of audit of a hospital. (6)**

**Ans.** Hospitals basically provide various services to the public. The systems of keeping accounts of both are almost same. The following points to be varied by the auditor at the time of verification of accounts of the hospital and nursing home:

1. **Constitution** The auditor should verify legal status like Trust Deed, Title Deeds, Acts and regulations of nursing home and hospital, etc.
2. **Internal Check** The auditor should investigate the internal check with respect to issues and receipts of stores, lines, apparatus, clothing and other equipment. He should confirm that purchase is made in accordance with purchase policies of the organisation.
3. **Checking of Different Registers and Documents** The auditor should check the stock register, asset registers and other documents of the organisation. He should ensure that these documents and registers maintained and recorded properly and authenticated by the appropriate authority.

4. **Verification of Income Related Transactions** The auditor should check/vouch the following-
   - (a) Donations or grants received from time-to-time from the Government, local authorities, municipalities and others. He should also see the accounting treatment of such receipts for the specific purposes.
   - (b) Billing and collection of money from the outdoor patients, patients in the general and private wards.
   - (c) Income from other sources like; rent, interest and dividend from investment, etc.
   - (d) All the documents relating to the income of the hospital with accounts of the hospital.
   - (e) The amount of outstanding and accrued income with the accounting entry.
   - (f) Explanations of the unbilled and concessional billing cases, if applicable.
5. **Verification of Expenditure Related Transactions** The auditor should check the following-
   - (a) Proper entry of capital and revenue expenditures in the books of accounts.
   - (b) Depreciation on different fixed assets as per the Companies Act and Income Tax Act.
   - (c) Purchase of medicines, stationeries, equipment, etc. and their entry in the books of accounts.
   - (d) Expenses relating to salaries of staff, wages, laundry, etc.
   - (e) Compare the actual expenses occurred with the budgeted amount and their proper utilisation.
6. **Assets** The auditor should see the entry of all the assets and their proper entry in the balance sheet.
7. **Liabilities** The auditor also must see the entry of all liabilities and their entry in the balance sheet.
8. **Stock Verification** Stock verification is necessary for reflecting actual position of the stock; like medicine, stationeries. So, the auditor should check the stock as and when required.
9. **Compliance with Accounting Standards** The auditor should verify the form and way of presenting financial information comply with the accounting standards and applicable statutory requirements.
10. **Management Representation and Certificate** The auditor will examine proper management representation and certificates with respect to various aspects covered during the audit course.

**12. (b) State the basic principles of Government Audit.** **(4)**

**Ans.** The basic principles of government audit may be discussed form two aspects:

**A. In Respect of Expenditure**

**(i) Conformity to Rules and Regulations** The auditor should ensure that expenditures incurred for undertaking different activities are in accordance with the rules, regulations and legal provisions of the competent authority.

**(ii) Sanctioned by Competent Authority** The auditor should ensure that expenditures incurred have been sanctioned by the appropriate competent authority.

**(iii) Maintaining Propriety** The auditor should ensure that expenditures that have been incurred are justified and that there is no unnecessary wastage of government funds, in other words public fund.

**(iv) Expenditure Within Provisions** The auditor should confirm that if expenditures have been incurred out of provisions and that they are within the prescribed limits.

**(v) Audit of Performance of Projects** The auditor should see that the projects involving huge amount of public money have been carried out efficiently, effectively and transparently.

**B. In Respect of Revenue**

**(i) Realisation of Amount** The auditor should check whether the amounts to be received or revenues to be earned have been assessed, realised and the same have been credited to the government account.

**(ii) Effective Check on Revenue Realisation** The auditor should ensure that there are effective rules and regulations relating to realisation and collection of government revenues.

**(iii) Effective Check on Irregular Events** The auditor should ensure that there is effective check system to detect and prevent irregularities, loss of revenue due to fraud, misappropriation on account of tax collection.

**(iv) Proper Accounting for Donations, Subscriptions** The auditor should ensure that the donations, subscriptions received have been properly accounted for.

**13. As an Auditor, how would you Vouch the following:**

**(i) Director's Remuneration** **(ii) Travelling Expenses** **(5+5)**

**Ans. (i) Vouching of Director's Remuneration**

***Documents to be Checked***

- Articles of Association
- Resolutions of the general meeting
- Minute book
- Agreement with the directors

- Director's attendance register
- Receipts issued by the directors
- Bank statement

***Procedures followed/ Duty of an Auditor***

(a) In general, the directors are not automatically entitled to remuneration. It is paid either according to the terms of Articles of Association or in accordance with a resolution of the general meeting. The auditor should examine the Articles of Association and resolution adopted in the General meeting in order to ascertain the mode of payment.

(b) He should refer to General meeting or Board meeting resolution for the appointment and terms of appointment of the director as per Section 196 of the Companies Act, 2013.

(c) He should also check the agreement, terms and conditions of appointment of the directors.

(d) Examine Articles of Association and General meeting resolution to determine the manner of payment – monthly or at a specified percentage of the net profits of the company or partly by one way and partly by the other as per the provisions of Section 197 (6) of the Companies Act, 2013.

(e) The auditor should verify director's attendance in the board meetings and minute book, if there is provision of payment of remuneration to the directors for attending the meeting.

(f) He should ensure compliance with the provisions of Sections 197, 198 and Schedule V to the Companies Act, 2013, where appropriate, regarding remuneration paid to directors.

(g) He should examine that the net profits and the commission payable to directors has been computed in terms of Schedule III to the Companies Act, 2013.

(h) He should ensure that a separate note has been given stating the computation of net profit under Section 198 of the Companies Act, 2013 with details of the commission payable as percentage of profits to the directors including managing directors/manager (if any).

(i) He should also examine adherence to relevant sections of the Act, such as

  (i) Section 309(3) and (4) which deals with manner of payment of managerial remuneration

  (ii) Section 309 (2) which deals with the payment of sitting fees

  (iii) Section 198 which has prescribed overall limits to managerial remuneration

**(ii) Vouching of Travelling Expenses**

***Documents required***

- Cash book
- Standard form for claiming reimbursement

- Ticket of the mode of transport used
- Hotel bill
- Travelling allowance rules of the organisation
- Approved tour programmes
- Tour report, if any

***Procedures followed/Duty of an Auditor***

(a) The auditor should check whether there is any approved rule for travelling expenses to be paid to staff. If no rule exists, he should recommend that rules should be framed to control the expenses.

(b) The voucher for travelling expenses should normally contain the following information:

  (i) Name and designation of the person claiming the amount
  (ii) Particulars of the journey
  (iii) Amount of railway or air fare
  (iv) Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station
  (v) Other expense claimed, e.g. porterage, tips, conveyance, etc.

(c) The auditor should examine the cash book for payments made for travelling expenses with reference to standard form for such reimbursement filled in by the claimant with his name and designation clearly indicated.

(d) He should check the counterfoil of the air ticket, if the journey was undertaken by air. For travels by rail or road, the amount of the fare claimed should be checked from some independent source.

(e) He should ensure that the tour was sanctioned by the competent authority.

(f) Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified in terms of rules, if any, framed by the entity in this regard.

(g) The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned.

(h) All vouchers for travelling expenses should be authorised in the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.

(i) In case of foreign travel expenses, the auditor should also examine the Reserve Bank of India's prescribed foreign exchange entitlement for such travel along with company rules in this regard.

(j) The travelling advance taken, if any, should be settled on receipt of final bills. At the year end, the amount not settled should be shown appropriately in the balance sheet.

(k) Section 309 of the Companies Act, 2013 provides that the travelling expenses of the directors for attending board meeting are payable provided they have been allowed by the articles, or by a Board's resolution or, if the articles so require, by a special resolution, passed by the company in its General meeting.

(l) The auditor must examine the Directors' Travel Rules framed by the company, if any, to ensure expenses are within the sanctioned limits.

or

**13. (a) "The term Verification of Assets includes Valuation also." – Justify the statement. (5)**

**Ans.** Verification means verifying the truth of the existence, values and ownership of the assets. Before signing his report, auditor has to satisfy himself that the assets shown in the balance sheet really exist, they are in the name of his clients and the values shown are proper.

The process of satisfying himself regarding all these points is 'verification'.

According to *Joseph Lancaster* "Verification of assets is a process by which the auditor substantiates the accuracy of the right-hand side of the balance sheet, and must be considered as having three distinct objects: (a) the verification of the existence of assets, (b) the valuation of assets and (c) the authority of their acquisition".

Valuation of assets means the examination of the accuracy and propriety of the valuation of those assets, which are shown in the Balance Sheet of any concern at the end of the financial year. So, valuation is an operation, which includes:

(a) obtaining all the necessary information regarding valuation,

(b) analysing all the figures available,

(c) confirming the fact that the valuation is being determined on the basis of generally accepted conventions and accounting principles,

(d) ensuring the consistency of the methods followed for the valuation from year-to-year, and

(e) obtaining an opinion regarding the accuracy of valuation.

Now the problem is what the correct value of an asset is. The assets would be deemed to be properly valued, if valuation is made according to the generally accepted accounting principles. Valuation is concerned with the determination of value of the assets and liabilities of an entity at which it will be disclosed in the balance sheet. As a broader concept, verification includes the valuation part of assets and liabilities. So, valuation of assets is a part and parcel of verification. Without proper valuation, the verification process cannot be completed.

While doing verification of assets, the auditor will not only see the existence and ownership of assets but also ensure the sanctity and propriety of the amount at which they have been shown. He will confirm that assets have been valued on the basis of generally accepted accounting principles and a consistent basis of valuation is being followed year after year. So verification has a broader perspective than valuation. It consists of valuation of assets and examination of existence and title of assets.

So, verification is dependent on valuation, which facilitates proper verification of assets and liabilities. Hence, it can be said that valuation is included in verification.

**13. (b) As an Auditor how would you verify 'Secured Loan'? (5)**

**Ans. Verification of Secured Loan** Secured loans are those loans that are protected by an asset or collateral of some sort. A company can obtain loans from banks and other financial institutions on the basis of security provided. The auditor should take the following steps to verify the secured loans:

(i) The auditor should examine the Memorandum and the Articles of Association to see whether the company is empowered to borrow money and any other restrictive provision, if any.

(ii) The auditor should verify the authority under which the loan has been raised. In the case of a company, only the Board of Directors is empowered to raise a loan or borrow from a bank.

(iii) He should ensure that the provision of Section 180 of the Companies Act, 2013 has been complied with in respect of restriction of borrowing power of the Board.

(iv) In the case of borrowings from bank, financial institution, company or firm, the auditor should inspect the related agreement to note the terms and conditions of the loan including nature of securities and the terms and condition of the loan including nature of securities and the terms of interest payment.

(v) In case of borrowing by issue of debentures, he should examine the prospectus, debenture trust deed, etc.

(vi) In case of loan against fixed assets, he should scrutinise the loan account in the ledger and the documents relating to the fixed assets. He should also examine the mortgage deed and find out whether the mortgage is properly executed.

(vii) If the loan was taken against stock, the auditor should inspect the receipts of the godown keeper. If the stocks are at dock or in bonded warehouse, the dock warrant or the warehouse certificate duly endorsed in favour of the lender should also be examined.

(viii) The auditor should also examine the purpose of taking loan and whether the amount of loan has been utilised for that purpose.

(ix) He should see whether principal amount of the loan is being repaid as stipulated and whether interest on loan are paid regularly as per the terms of loans as prescribed in CARO.

(x) The auditor should ensure that the secured loan has been disclosed in the balance sheet as per the Schedule III of the Companies Act, 2013.

(xi) He should obtain certificate from the lender to confirm the validity of amount of loan shown in the balance sheet and interest thereon.

**14. (a) Distinguish between Internal Check and Internal Control System. (4)**

**Ans.** The difference between Internal Control and Internal Check are as follows:

| Items | Internal Control System | Internal Check |
|---|---|---|
| **Nature** | Internal control system is the whole system of control. | Internal check is only a part of internal control. |
| **Scope of work** | It exercises control over all the areas of a function. | It is concerned with the work allocation only. |
| **Function** | Implementation of internal control is the responsibility of the management staff. | Internal check can be carried out by the ordinary staff. |
| **Importance** | It is concerned with operational efficiency, productivity and profitability of the organisation. | It is mainly concerned with record keeping and accounting reports. |
| **Flexibility** | It deals with overall control of the organisation with flexibility. | It is comparatively less flexible. |
| **Internal elements** | Internal control system includes internal check, internal audit and administrative control. | It has no internal element. |

**14. (b) Can the Statutory Auditor rely upon the Internal Auditor? Justify your answer mentioning relevant Standard of Auditing (SA). (6)**

**Ans.** SA-610 (earlier AAS-7), issued by ICAI, states that the external auditor can use the work of the internal auditor after evaluation of internal audit functions. Accordingly, the following factors should be considered while determining the extent to which the external auditor can rely on the work of internal auditor:

(i) whether internal audit is undertaken by an outside agency or by a separate audit department within the entity
(ii) the scope of internal audit, management action and the internal audit report
(iii) experience and qualification of the internal auditor
(iv) technical compliance by the internal auditor
(v) authority vested on the internal auditor and the level of management to whom he is accountable
(vi) whether professional care has been taken by the internal auditor in conducting audit work

The above statements suggest the following features:

- The role of the internal auditor is determined by the management and differs from that of the external auditor.
- The external auditor should evaluate the internal audit function to the extent it is relevant for determining nature, timing and extent of his compliance and substantive procedures.

- The responsibility of the external auditor cannot be reduced due to reliance on the work of the internal auditor.

Thus, to conclude, it can be said that the external auditor can rely on the work of the internal auditor, but if any misstatements remain undetected, the external auditor will be held liable for negligence in his duty.

or

**Prepare an Internal Control Questionnaire for purchase of goods of a manufacturing concern.** **(10)**

**Ans.** The Internal Control Questionnaire for purchase of goods of a manufacturing concern should include the following questions:

(i) Is there a separate department for purchase?
(ii) Are tenders invited before placing orders?
(iii) Are purchase requisitions prepared?
(iv) Are purchases made on the basis of a written order?
(v) Are purchase order forms serially numbered?
(vi) Is the purchase order form a standard one?
(vii) Does the purchase order form contain relevant fields only?
(viii) Is there a purchase committee to execute the purchase transactions?
(ix) Is the purchase order file securely preserved?
(x) Is the purchase order authorised and approved by responsible officers?
(xi) Is the copy of the purchase order sent to the accounts department, receiving department and stores department?
(xii) Are the materials inspected on being received?
(xiii) Does the receiving department communicate with the purchase department and the accounts department on receipt of the material along with the report of inspection?
(xiv) Is the challan on purchase of material verified with the purchase order?
(xv) If credit purchases are made, are the invoices verified with the purchase orders and challans?
(xvi) Are the invoices approved by the responsible officer?
(xvii) Do all the invoices bear stamps to avoid duplication?
(xviii) Is there a system of inter-unit purchase?
(xix) Is the purchase ledger maintained manually or computerised?
(xx) Is the payment made in a/c payee cheque?
(xxi) If there is inter-departmental transfer, then is the transfer priced at cost or invoice price?

**15. (a) 'An Auditor is not responsible for any undetected error and fraud unless there is any Cause for Suspicion.' – Give your answer with relevant case laws and decisions.** **(6)**

**Ans.** The responsibilities of an auditor in relation to errors and frauds remaining undetected are largely determined by the available legal decisions and professional promulgations.

**Legal Decisions** The auditor's duty in detecting and preventing errors and frauds has been recognised in a number of legal decisions. In *London* vs. *General Bank (1895)* case, it was held that an auditor must exercise reasonable care and skill in conducting his audit work. However, he is not an insurer and never guarantees that the books of accounts are free from errors. Hence, if any such error remains undetected even after conducting the audit with reasonable skill and care, the auditor cannot be held liable. In *Kingston Cotton Mills Co. (1896)* case also, it was held that 'an auditor is a watch dog and not a blood-hound'. Hence, if there is anything suspicious, the auditor must look into such matters thoroughly, but in the absence of any such suspicious matters, he shall be relieved of his liability, if it is proved that he has exercised reasonable skill and care in performing his job.

Thus, detection of frauds and errors is not the primary responsibility of the auditor. However, in the course of audit, he must be alert to all such possibilities. But, if the errors and frauds are not detected even after careful conduct of audit, the auditor should not be held liable for such not detection.

**Professional Promulgation** SA-240 on 'The Auditor's Responsibility related to Fraud in an Audit of Financial Statements' contains detailed previsions regarding the duty of an auditor in detection and prevention of errors and frauds. The summary of these provisions are given below:

(a) The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.
(b) The auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.
(c) The auditor shall maintain an attitude of professional skepticism throughout the audit. He should be alert to any possibility of material misstatements.
(d) The auditor should identify fraud risk factors, i.e., events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.
(e) If he has any doubt as to the authenticity of any document, he shall enquire into the matter.
(f) He shall hold discussion with the audit engagement team on how and where the entity's financial statements may be susceptible to material misstatement due to fraud.
(g) He shall evaluate the effectiveness of internal control system.
(h) He may design and perform further audit procedure based on his assessed risk of material misstatement.
(i) In case the auditor finds any material misstatement, he shall evaluate whether such misstatement is an indicator of fraud.
(j) He shall communicate all errors and frauds identified during audit to the management and shall ask proper explanation from the management.
(k) In case of minor misstatements, he shall ask the management to rectify the same immediately.

(l) In case he faces any resistance from the management and is unable to continue his work, he must withdraw his engagement and shall inform the regulatory authorities about the same.

(m) He shall submit qualified or adverse report in case the misstatement is so severe that it materially affected the true and fair view of the financial performance and the state of affairs of the entity.

Thus, we may conclude that an auditor is not responsible for any undetected error and fraud unless there is any cause for suspicion.

**15. (b) Define Interim Audit. Mention any two requirements for which an Interim Audit is done.** **(2+2)**

**Ans.** It is an audit which is conducted in between the two periodical or balance sheet audits with a view to find out interim profits in order to enable the company to declare an interim dividend. The purpose is to minimise the work and time involved in concluding the audit after the fiscal year. It may be conducted monthly, quarterly or half yearly.

Two requirements for which an interim audit is done are as follows:

1. **Publication of Interim Report** Interim audit is very useful in cases where publication of interim report is essential. Moreover, this will also help in declaration of interim dividend.
2. **Important for Partnership Firms** In the case of admission of a new partner or in the event of retirement or death of an existing partner, interim audit is very helpful in determining the position of assets and liabilities.