INCOMETAX AND PRACTICLA AUDITING (DBC32)

(BACHELOR OF COMMERCE)

ACHARYA NAGARJUNA UNIVERSITY

CENTRE FOR DISTANCE EDUCATION

NAGARJUNA NAGAR,

GUNTUR

ANDHRA PRADESH

LESSON - 1

INTRODUCTION

1.0. Object : After going through this lesson the student can know what is auditing ? What are the objects and advantages of Auditing ?

Structure :

1.1. Introduction :

The practice of auditing accounts may be traced back to the early stages of civilisation. In those days audit was undertaken mainly for state or public accounts. The historical records of auditing show that ancient Egyptians, Greeks and the Romans used to get their public accounts audited. Audit of accounts of Private business houses was rare as the size of the business houses was small and management and ownership were joint.

The system of accounting and auditing is believed to have existed in our country under the Mauryas, Chandra Gupta and other Hindu Kings. Kautilya, in his Arthashastra had mentioned about the accounting and auditing of state finance. He also listed various kinds of frauds and prescribed punishments to deal with them. However, the growth of the Accounting Profession in India is of a recent origin.

Auditing as it exists today can be associated with the introduction of large scale production as a result of Industrial revolution during the 18th century.

The introduction of joint stock form of organisation widened the scope of investment and business activities. Business community started raising money from public and also borrowed capital from various private and state financial institutions. Under company form of organisation the investors called as shareholders delegate the management of the undertaking in which they have invested their money to a Board of Directors but they would be keenly interested in the safety of their investment. As the shareholders are drawn from far off places and are not at the helm of the affairs of the company. In these circumstances need for getting the accounts audited arose.

The Indian companies Act had made it compulsory for all the corporate bodies to get their accounts audited by qualified professional accountants.

1.2. Definition:

The word audit is derived from the Latin word 'Audire' which means " 'to hear'. In olden days whenever the owners of the business suspected fraud they appointed certain persons to check the accounts. The auditor use to hear the accounts of the parties relating to financial transactions. It was in fact a cash audit. But Now-a-days the auditor verifies the accounts to find out their accuracy. Thus the modern audit is not merely a cash audit but also an audit of final accounts.

'Auditing' means an examination of the accounts books and the relative documentary evidence by an independent qualified person in order to ascertain the accuracy of the figures appearing there in.

Some of the definitions given by different writers are given below :

Montgomery a leading American accountant and auditor, has define auditing as "a systematic examination of the books and records of a business or other organisation in order to ascertain or verify and the report upon the facts regarding the financial operations and the results thereof".

Spicer and pegler have defined an audit as "such an examination of books and accounts and vouchers of a business as will enable the auditor to satisfy himself that the Balance sheet is properly drawn out so as to give a true and fair view of the state of affairs of the business and whether the profit and loss account gives a true and fair view of the profit or loss for the financial period, according to the best of his information and explanation given to him and as shown by the books and if not in what respect he is not satisfied."

According to Dickse "auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate. But this is not the end of the matter, in addition the auditor also expresses his opinion on the character of the statements of accounts prepared from the accounting records so examined whether they portray a true and fair picture".

Mautz defines auditing as being "concerned with the verification of accounting data, with determining the accuracy and reliability of accounting statements and reports".

After going through the above definitions in simple words we may say that auditing is a critical and intelligent examination of the books of accounts with relevant vouchers and documents to ascertain whether the profit or loss shown by the profit & loss account and financial position as shown by the balance sheet are fair and true.

1.3. Objects of an Audit :

The main object of an audit is to find out after going through the books of accounts whether the Balance sheet and profit and loss account are properly drawn up according to the companies Act and whether they represent a true and fair view of the state of affairs of the concern. Detection and prevention of errors is the subsidiary object of modern audit.

Thus in general auditing may be defined as "Science of verifying the records and reports which reflect the financial condition and operating results of the business."

1.3.a. Verification of Accounts and statements :

The primary object of an audit is to establish, by an examination of books, vouchers and other appropriate records that the balance sheet, at a given date, is properly drawn up so as to exhibit a true and fair view of the state of affairs of the business and the profit and loss account discloses the correct profit or loss for the period. His primary object always is the establishment of the degree of reliability of the annual statements of accounts.

An audit is also intended to disclose how far the system of accounting which is being followed has been successful in correctly recording the transactions as well as the weaknesses that there may be in its organisation. The companies Act requires an auditor to report whether books of accounts are kept in accordance with the Act and whether they show a true and fair view of the state of affairs of the company.

1.3.b. Detection and prevention of Errors :

A) Error may be defined as "Mistake of negligence or misjudgment without an intention to fraud."

Audit aims at finding out errors if any in the accounts. Errors may arise at various stages in Book-keeping records. The errors may arise because of the carelessness of the clerks or their ignorance of the principles of accounts. The former are called clerical errors and the later are called errors of principles, clerical errors are of four kinds.

1) Errors of Ommission

2) Errors of Commission

3) Errors of Duplication

4) Compensating errors

1) Errors of Ommission :

These errors arise when any transactions are not recorded in the books either wholly or partially. Complete omission will not effect the Trail Balance. So the auditor has to take special care to detect such ommission. Ommission to enter purchases in the purchases book, omission to enter sales in the sales book and non Provision for outstanding expenses are some of the examples of complete ommission . Partial ommission will effect the trail balance. So the auditor can detect them easily. These errors affect the accounts and profit and loss account materially. They may even effect Balance sheet.

2) Errors of commission :

These are most common. These errors arise when any transaction is incorrectly recorded or posted. They consists of wrong entries postings, castings and calculations and carry forwards. Most of these errors will affect the agreement of trail balance. So they can be detected by a cautious routine checking. But errors in calculations will not affect the agreement of the trail balance. So detection of such errors is not easy.

3) Errors of Duplication :

These errors arise when any transaction is entered twice in the books of original entry and posted twice in the ledger. They will not cause the disagreement of trail balance. So detection is not easy.

4) Compensating Errors :

A compensating error may arise when errors counter act each other. It is a dangerous type of error. It may or may not affect the profit and loss account of the business. It will not affect the agreement of trail balance so detection is not easy. For example X account was credited by Rs.200 instead of Rs.800. There was a short credit of Rs.600, while Z account is debited by Rs.200 instead of Rs.800. Thus there is a short debit of Rs.600. It means that there was a short credit and short debit of Rs.600 each. Here one error was exactly counter balancing an other error. These errors are also known as off setting errors because the effects are off-set.

Errors of principle :

These errors arise when transactions are not recorded in the books of accounts according to the accepted principles of accountancy. These errors may be committed purposely or accidentally. They will not affect the trail balance but they will affect the profit and loss account and balance sheet to a great extent. The auditor must always be on the look out for such errors. These can be detected by searching enquiry and independent checking.

Wrong valuation of assets,wrong distribution of expenditure between capital and revenue, incorrect provision for depreciation or bad and doubtful debts are some of the examples of errors of principle.

Location of Errors :

The question is how to locate an error if the trail balance does not agree and the auditor is called upon to locate the error although it is not his duty to do so. The following steps will ease the work.

1) Check the totals of the trail balance.
2) Compare the names of the accounts in the ledger with the names of the accounts as have been recorded in the trail balance.
3) Total the lists of debtors and creditors and compare them with the trail balance.
4) If the books are maintained on the self balancing system, see that the total of different accounts agrees with the total of these accounts with the balance of accounts as recorded in the trail balance.
5) Compare the items of the trail balance, halve it and see if there is any item of this value. This is done to avoid the putting of the debit balance on the credit side of the trail balance or vice Versa.
6) Compare the items of the trail balance with the items of the trial balance of the previous year to see if any item has bee ommitted.
7) It is possible that the totals of some subsidiary books e.g : cash book, purchases book, sales book etc; might not have been transferred to the trail balance. Re-check the totals of these books.
8) If an error is divisible by 9 may be due to misplacement e.g. writing 32 as 23.

Detection of Frauds :

Frauds are planned and intentional errors with a view to defraud. Detection of fruad is more difficult than the detection of errors. Detection of fraud depends upon the efficiency of the internal check in operation. As a rule, frauds can be detected easily in the early stages. But it is difficult to detect them if they assume complications. The scope for committing fraud depends upon the supervision of the proprietor division of work and the system of internal check in operation.

Frauds may be committed mainly to three ways.

1) By misappropriation of money.

2) By misappropriation of goods

3) Manipulation of accounts.

Cash can be misappropriated in two ways, 1) By ommission of receipts by acknowledging a lesser amount than what actually received. 2) By inclussion of fictitious payments or recording more payments than actual payments. Ommission of receipts can be detected by checking the debit side of the cash book and sales mans dairy, counterfoil of receipt book etc.

Goods which are less bulky but more valuable can be easily misappropriated. Detection of such misappropriation is not easy. The success of detection depends upon the accuracy of stock records.

Accounts are manipulated to conceal the real position of the concern. It is usually committed by directors of managers or other responsible officials with the object of showing more profit than what actually they are to sell the shares at high prices by declaring high dividends to obtain further credit by showing the financial position of the business better than what actually it is or to attract more subscribers for the sale of shares of the company etc.

Prevention of errors and frauds is possible only by application of sound system of internal check and suitable management of the concern. The auditor must suggest methods to the management for preventing the recurrences of errors and frauds in future.

1.4. Advantages of an Audit :

On account of the following advantages people get their accounts audited.

1. Errors and frauds are located at an early date and in future no attempt is made to commit such frauds.
2. The auditing of accounts keeps the accounts clerks regular and vigilant in their work.
3. In case of fire the insurance companies may settle the claim on the basis of audited accounts of the previous years.
4. Money can be borrowed easily on the basis of previous audited Balance Sheet.
5. If the business is to be sold as a going concern there will not be much difficulty regarding the valuation of assets and goodwill as the accounts have already been subject to audit by an independent person.
6. Income tax authorities generally accept the profit and loss account which has been prepared by a qualified auditor and they do not go into the details of accounts.
7. The management may consult the auditor and seek his advice on certain technical points although it is not the duty of an auditor to give advice.
8. Accounts of one year can be compared with other years and if there is any discrepency the causes may be enquired into.

9. The audited accounts are considered more or less correct by the sales tax authorities.

10. It would facilitate the settlement of the accounts of a deceased partner.

11. An auditor acts as trustee of the shareholders and safeguard their financial interest in the case of a joint stock company. Shareholders are assured that the accounts have been properly maintained and the directors and managers of the company have not taken any undue advantages of their position.

12. Audit safeguards the interest of the workers because audited accounts are useful for settling trade dispute for higher wages or for payment of bonus to the workers.

1.5. Qualities of an Auditor :

The person who conduct audit is known as the auditor. He makes a report to his appointing authority after careful examination of the accounting records and the accounting statements. In this report he expresses his opinion whether the statements of account are true and fair or not. For this purpose the auditor need the following qualities.

1) It is very important for an auditor to be well versed in the fundamental principles and theory of all branches of accounting; ex : Financial Accounting, cost accounting; Income tax etc. It is not possible for a person to audit the accounts unless he himself knows how to prepare them. He should not pass a transaction unless he himself knows that it is correct. This is possible only when one knows thoroughly well the principles of accounting.

2) He should be able to grasp quickly the technical details of the business whose accounts he is auditing. If possible he should pay a visit to the works of his client before he commences his work.

3) He should be prepared to seek elucidiaton technical questions rather than show a false pride or fear of displaying his own ignorance.

4) He should quite familiar with the company and mercantile laws and must be complete master of the principles of auditing.

5) He must be tactful and honest as Lord Justice Lindley has said "An auditor must be honest i.e. he must not certify what he does not believe to be true and he must take reasonable care and skill before he believes what he certifies is true". (In London & General Bank).

6) He must not be influenced directly or indirectly by others in discharging his duties.

7) Sometimes he is put in a very ackword position when his duties to his client is opposed to his own interest in which case he must have the courage to carry out his duty faithfully, and honestly even if such a step harms him.

8) He must be prepared to resign rather than sign a Balance Sheet which he knows does not exhibit a true and fair view of the state of affairs of a concern and thus gives a false report.

9) He should not disclose the secrets of his client.

10) He must have the tact to put some intelligent questions to extract full information.
11) He must be prepared to hear the arguments and must be reasonable.
12) He must be vigilant, cautious, methodical and accurate.
13) He should have an understanding of the general principles of Economics.
14) He should have thorough training in business organisation, management and finance.
15) He should have common sense and the ability to write the report clearly, correctly, concisely and forcefully.
16) An auditor need not be unduly suspicious. As Lord justice Lopes said, "An auditor is not bound to be a detective or to approach his work with suspicion or with foregone conclusion that there is something wrong.” (In Kingston Cotton Mills Co. case)

1.6. Distinction between accountancy and auditing :

Accountancy may be defined as the science as well as the art of recording business transactions in the financial books. The person who is concerned with the recording of business transactions in the financial books is known as an accountant. He maintains accounts and prepares the profit and loss account and Balance Sheet but he will not give guarantee of the correctness of the accounts which he prepares. He will not certify the Balance Sheet as true and fair, he can only say that the Balance Sheet is in accordance with the books. He will not certify the Balance Sheet as true and fair, he can only say that the balance sheet is in accordance with the books.

Accountancy is quite distinct from auditing. The following are the main differences between accountancy and auditing.

Accouantancy	Auditing
1) Accountancy is concerned with the writing of books or the prepration of accounts.	1) Auditing is concerned with the examination of such books or accounts to ascertain their accuracy.
2) Accountancy is primarily constructive and concerned with recording of business facts	2) Auditing is analytical and essentially retrospective in nature.
3) Accoutancy is the original work.	3) Auditing presupposes the existence of accounts. It gives finishing touch to accounts. An audit commences after the accounting are ready. It is said that audit really begins where accountancy ends.
4) Accountancy involves the preparation of final accounts.	4) An auditor verifies their accuracy and certifies that they represent a true and fair view of the state of affairs of the concern. Thus the auditor verifies what the accountants have done.
5) No qualification is prescribed for the accountants of a joint stock company. Any person having specialised knowledge of the principles of accountancy is eligible for appointment as an accountant of a joint stock company.	5) But only persons who satisfy the qualifications prescribed by the Indian Companies Act are eligible for appointment as auditor of joint stock companies.

Distinction between Accountancy and Auditing is of great importance. An auditor must clearly know as to whether he is working in the capacity of an auditor or accountant.

In the case of Apfel Vs Anna Dexter & Co (1929), it was sought to prove that the auditor had acted in the capacity of auditors and therefore, they were liable for negligence in detection of a fraud.

The auditors contention was that they were employed to prepare the books of accounts for Income tax purpose and not to do the work of an audit. The certificate given by the auditors was prepared from the books of "Mrs. Adele Apfel and in accordance there with". But they had sent the bill for costs which was worded as "for services in connection with the preparation and audit of your accounts".

From the certificates given by the auditors it is clear that the work done by them was of a purely accountancy nature while the bill sent by them was both of accountancy and auditing. Austbury J. gave the judgement in favour of the auditors taking into consideration the object and the purpose for which the auditors were employed.

In the case of commissioner of Income tax Madras Vs G.M. Dandekar 1956. It was held by the Madras High court that the auditor was employed to prepare incometax returns and did not act in the capacity of the auditor of his employer.

1.7. Summary :

Auditing is a critical and intelligent examination of the books of accounts with relevant vouchers and document to ascertain whether the profit or loss shown by the profit and loss account and financial position as shown by the balance sheet are fair and true. Detection and prevention of errors is the subsidiary object of modern audit. Errors are of two types clerical errors and principle errors. Error may be defined as a mistake or misjudgement without an intention to defraud the concern. A Fraud may be defined as intentional errors with the object to defraud the concern. It is compulsory to audit the account of a joint stock company. The auditor must distinguish his duties whether he has been appointed as an accountant or an auditor.

1.8.Self Assessment Questions :

1. Define an "Audit" and state the various objects of an audit.
2. What are the different types of frauds in connection with accounts ?
3. Distinguish accountancy and auditing ?
4. What are the essential qualities required of an auditor apart from the statutory qualifications.
5. Write short notes on the following :

a) Location of errors

b) Detection and prevention of errors.

c) Detection and prevention of frauds.

6. What are the advantages of an audit ? Briefly state the qualities of an auditor.

7. What are the main objects of an audit ?

1.9. Recommended books

Principles of Auditing	**:**	**R.G. Saxene**
Principles & Practices of Auditing	**:**	**B.N. Tandon**
Principles & Practices of Auditing	**:**	**Jegadish Prakash**
Contemporary Auditing	**:**	**Kamal Gupta**

-Dr. Ch. Suravinda

LESSON - 2

TYPES AND CONDUCT OF AUDIT

2.0. Object : After going through this Lesson the student can know the various types of Audit and How it is conducted ?

Structure :

2.1. Introduction.

2.2. Various types of audit

2.3. Audits under statute

2.4. Audit of the accounts of a private individual.

2.5. Audit of the Accounts of private Firms.

2.6. The Audit of Trust Accounts

2.7. Conduct of an audit.

2.8. Continuous Audit

2.9. Periodical or Final Audit

2.10. Distinction between Final Audit and continuous Audit

2.11. Interim Audit

2.12. Partial Audit

2.13. Balance Sheet Audit

2.14. Occassional Audit

2.15. Summary

2.16. Self Assessment questions

2.17. Recomended books

2.1. Introduction :

It is not obligatory to the sole traders or partnerships, under law, to get their accounts audited but because of the advantages derived they generally have their accounts audited.

2.2. Various Types of Audit :

Audit may be of different classes but the principal classes of audit are :

1) Audit under statute (Law);

2) Audit of the accounts of private individuals;

3) Audit of the accounts of private firms;

4) Audit of the accounts of trustees and executors etc.

2.3. Audit under statute :

Audits are compulsory in the case of undertakings mentioned below, under the different laws that govern them

a) Joint stock companies incorporated under the companies Act, 1956.

b) Banking companies governed by the Banking companies Regulation Act, 1949.

c) Insurance companies governed by the Insurance Act, 1938.

d) Co-operative societies registered under the co-operative societies Act.

e) Public and charitable Trusts registered under various religious and other endowment Acts.

f) Local authorities and govt. undertakings.

Audit is of two types it may be a statutory audit or general audit. It is not compulsory to any partnership firm or sole trading concern to get their accounts audited, but it is optional, such an audit is known as general audit. When an auditor is asked to audit the accounts of a firm he must get clear instructions in writing from his client to know the scope of his work.

Audit is compulsory in case of joint stock company according to the company Act. The audit of accounts of a joint stock company is known as statutory audit.

Advantages :

1) The share holders of a company have no access to the books of accounts and therefore if the accounts are audited by an auditor who is an independent professional accountant, they are assured that they have not been defrauded.

2) An audit act as a check upon the dishonest employees whose number may be very large.

Distinction between the audit of a joint stock company and a firm :

Joint Stock Company	Firm
1) The audit of Joint stock company is compulsory under the companies Act.	1) Audit is not compulsory in case of partnership firm.
2) The duties, powers, rights etc, of an auditor of a joint stock company are defined by the Companies Act.	2) They depend upon the agreement between the auditor and firm.
3) He must be a qualified person as laid down under (Sec.226)	3) He need not be a qualified person.

Here the student must also know the difference between audit of government offices, and commercial undertakings. The book keeping system as is adopted by the commercial concerns is not followed in government offices although their objectives may be the same. The audit system in government offices is therefore not similar to that of the commercial concerns. First of all we will discuss the objectives of the government Audit.

Objectives of government Audit :

The objectives of government Audit are as follows :

1) To see whether there is a provision of fund for the expenditure and whether such a fund has been duly authorised by competent authority.
2) To see that the expenditure has been properly sanctioned according to the rules and regulations.
3) To see whether the sanctioned expenditure has been incurred by an officer competent to incur such an expenditure.
4) To see that the amount has been paid to the proper person and the relative receipt has been obtained.
5) To see that the payment has been properly and correctly classified.
6) To see whether the payment is to be debited to the personal account of a contractor or an employee.
7) To see while auditing the receipts that money due from others is regularly recovered and checked against payment already made and the amount received is duly credited to the account concerned.
8) To see while auditing the stores and stocks, whether they are properly and accurately valued.
9) To see that the stock taking of the stores is periodically done or such stores may be verified with the balance as shown in the stock Register.
10) To see that the expenditure confirms to the general principles like, that the expenditure is not more than what is necessary and that every Government servant has exercised reasonable care to spend the money; and the public money is not utilised for the benefit of a person or section.
11) To see that the allowances should not become a source of profit to the receipient.

Distinction between the Audit of Government Accounts and Commercial Concern :

The following are some of the important distinctions between government audit and commercial audit.

Government Audit	Commercial Audit
1) The audit of government transactions, whether in or outside India is entrusted to the Audit and Accounts department which is quite independent of the spending department. It compiles of the major portion of the accounts which it audits.	1) In the case of commercial firms the auditor never prepares the accounts which he has to audit.
2) The spending department in case of Government offices, itself performs a part of the work incidental to audit as the audit officer has no knowledge of the quantity or quality of work done by a contractor or goods supplied by the supplier etc.	2) In the case of commercial concerns the audit work is not performed by the spending department.

3) Treasury officer who is not a member of the Accounts and Audit Department, makes the preliminary examination of the bills while making the payment on Government accounts.	3) In case of commercial firms, the cashier has nothing to do with the audit or preliminary examination of the bills which are paid by him.
4) A government audit is continuous audit because of a very large number of transaction and also because a large part of the work is concerned with the personal claims of Government officers and which have to be finalised with greate speed.	4) Commercial Audit is, in a majority of cases periodical.

2.4. Audit of the Accounts of a private individual :

Sole proprietors are not required by any law to have their accounts audited. Despite this fact it is quite usual for many of them who receive their incomes from different sources and whose expenditure is vast and varied, to get their private accounts audited. In such cases the auditor acts as an accountant also and prepares the accounts besides checking their accuracy. When he is appointed by an individual, he must get clear instructions from his client in writing as to what he is expected to do. His scope of work will depend upon the agreement that he has entered into with the client. In case the auditor is asked to do the full audit he must see that the accounts are properly prepared and the Balance sheet is correctly drawn-up in order to avoid his responsibility.

Advantages :

The following are the advantages to be derived by private individual by getting his account audited :

1) The individual is assured of having his accounts properly maintained and there is no fraud of any type by the accountant.
2) The audited accounts are generally taken as correct by the income-tax authorities for fixing the tax payable.
3) The audited books of a deceased are very helpful to the executors and administrators in preparation of the death duty accounts.
4) Wealth tax can be properly assessed.
5) The appointment of an auditor keeps a check on the accounts department.

2.5. Audit of the Accounts of Private Firms :

It is not necessary that the accounts of a firm should be audited but since there are many advantages of getting the accounts audited, many firms generally makes a provision for audit in the Partnership Deed. In such a case an auditor is appointed by an agreement between the auditor and his client. He should always bear in mind that all the partners jointly and severally are his clients, though he might have been appointed by only one of them, if so authorised under the partnership deed. He must get in writing the nature and scope of his work which is to be carried out and should make a written report in turn which can leave no doubt as to the nature of duties undertaken.

Advantages :

The following are the advantages to be derived by a partnership firm by getting the accounts of a firm audited by a qualified auditor.

1) Disputes among partners may be avoided.
2) In the case of admission, retirement or death of a partner, the valuation of goodwill and the settlement of accounts may become very easy.
3) Audited accounts will be more reliable for the purpose of assessment of income-tax.
4) Negotiations for loan from different sources become easy.
5) Auditor can suggest better ways of keeping the accounts.

In addition to the above mentioned particular advantages, a firm derives all the advantages which are usually derived in getting the accounts audited.

2.6. The Audit of Trust Accounts :

Trusts are created for the benefit of some religious or charitable institutions such as temples and educational institutions. In some cases trusts may be created for the benefit of Minors and widows who cannot look after the property themselves. The trustees took after the property left over by the testator. They collect the rents of the property, dividends on the shares etc., and distribute the income to the beneficiaries according to the terms of the Trust Deed. In many cases these trustees may not have the necessary knowledge of maintaining accounts or may not use the income of the trust for the benefit of the party for which it has been created. In other words, they may misappropriate the trusts funds without the knowledge of the beneficiaries. To avoid such a thing, generally a provision is made in Trust Deed for audit of accounts by a qualified auditor. If the accounts are audited, it helps both the trustees and the beneficiaries. Trustees will be benefited because there will be no unnecessary criticism against them, and the beneficiaries will be assured about the correctness of the accounts.

2.7. Conduct of an Audit :

An audit may be

1) Continuous Audit
2) Periodical Audit
3) Interim Audit
4) Occassional Audit
5) Partial Audit
6) Standard Audit
7) Balance sheet Audit

Now we will go through with each of the conduct of Audit and their relative advantages and Disadvantages one after the other.

1) Continuous Audit :

It is also called a detail audit which involves a detailed examination of books of accounts at regular intervals of say one month or three months. The auditor visits his clients at regular or irregular intervals during the financial year and checks each and every transaction. At the end of the year he checks the profit and loss Account and Balance sheet.

Businesses where continuous Audit is Applicable :

1) To those concerns where it is desired to present the accounts just after the close of the financial year as in the case of a bank.
2) Where the volume of transactions is very large.
3) Where the statement of account is required to be presented to the management after every month.
4) Where no satisfactory system of internal check is in operation.

Advantages of continuous Audit :

1) Errors and frauds can be discovered easily and quickly as the auditor checks the accounts at regular intervals and in detail.
2) Since the auditor remains more in touch with the business he is in a position to know the technical details of it and hence can be of great help to his clients by making valuable suggestions.
3) Most of the checking was having been already performed during the course of the year, the final audited accounts can be presented to the shareholders soon after the close of the financial year at the annual general meeting.
4) As the auditor visits the clients at regular intervals, the clerks will be very regular in keeping the accounts up-to-date.
5) If the auditor pays surprise visits it will have a considerable moral check on the clerks preparing accounts.
6) The auditors having more time at his disposal can check the accounts with great attention and in detail, so his work will be more efficient.
7) Where the directors of a company wish to declare an interim dividend continuous audit will help in the preparation of the interim accounts without much delay.
8) Audit staff can be kept busy throughout the year.

Disadvantages :

1) The figures in the books of accounts which have already been checked by the auditor at his previous visit may be altered by a dishonest clerk.
2) The frequent visits by the auditor may dislocate the work of his client.
3) It is an expensive system of audit.

4) The audit clerk may loose the thread of his work thus continuous audit lacks continuity in work.

5) The staff of the client may depend upon the audit staff to help them out of difficulties in the course of their work.

6) Extensive note taking may be necessary in order to avoid any alteration in the figures after the audit.

These disadvantages may be avoided by taking the following precautions.

1) No alteration shall be allowed to be made after the entries have been checked.

2) If any alteration has to be made it should be done by means of rectifying entry in Journal.

3) Checking of a book should be complete as far as possible in one visit to avoid loose ends. However if this is not possible he should check the transaction upto a particular date and make a note of it in his dairy.

4) If any alteration in a figure had already been made, the auditor should put a secret tick against such a figure.

5) He should pay surprise visits to the clients office.

2.9. Periodical or final audit :

Periodical audit is one which is taken up at the close of the trading period, when all the accounts have been balanced and trading and profit and loss Account and Balance sheet prepared. The audit is completed in one continuous session. In this case the auditor visits his client only once in an year and goes on checking the accounts until the audit work for the whole of the period is completed.

If the auditor has several clients whose financial year ends on the same date, it may be difficult for the auditor to complete the work of all his clients

Though this type of audit is called complete or Detailed Audit the expression is not correct because each and every transaction is seldom checked in a big business house. This type of audit is suitable to small concerns where the number of transactions are small in number.

2.10. Distinction between Final Audit and continuous Audit :

Continuous Audit	Final Audit
1) The auditor visits his staff frequently and check the accounts.	1) The auditor visit the client only at the end of the year and check the accounts in a single sitting.
2) Accounts are audited as and when recorded .	2) Accounts are audited after the preparation of final accounts.
3) It is suitable to big concerns and where a detailed checking is necessary.	3) It is suitable to small concerns.
4) It is an expensive one.	4) It is relatively cheap.

2.11. Interim audit :

It is an audit which is conducted in between the two annual audits with a view to find out interim profits to enable a company to declare an interim dividend.

Advantages :

1) This type of audit is good where the publication of the interim figures is necessary.
2) The final audit can be completed very soon, if there has been an interim audit.
3) Errors and frauds can be more quickly found and detected during the course of the year.
4) There is a moral check on the staff of the client as the accounts are checked say after three or six months.

Disadvantages :

1) Figures may be altered in the accounts which have already been audited.
2) It will mean that the audit staff will have to prepare notes when they finish the interim audit.
3) This is an additional work.

Distinction between continuous Audit and Interim Audit :

For better understanding of the interim audit and continuous audit the following points of distinction between them is provided to the students.

Continuous Audit	Interim Audit
1) The work of audit is carried on up to any date according to the convenience of the auditor and his client.	1) The work of audit is up to a definite date according to the instructions of the client.
2) Verification of assets and liabilities is done after the balance sheet has been prepared at the end of the accounting period.	2) The Assets and liabilities are verified when this audit is conducted.
3) No trail balance is prepared though the totals of certain accounts may be noted.	3) The trail balance has to be prepared or checked.
4) The object is not to know the profit or loss.	4) It is conducted to know the profit or loss.

2.12. Partial Audit :

When an auditor is asked to check some of the records and books for a part or whole of the period, it is called partial Audit eg : he may be asked not to check the payment side of the cash book. Partial audit is not permitted in the case of private or public limited companies.

2.12. Balance sheet Audit :

It is an audit to verify the items appearing in the Balance sheet and the profit and loss Account. It is a limited audit in which all the balance sheet accounts i.e. assets liabilities, reserves and provisions are verified. Those items of profit and loss account are only checked which are directly related to assets. In this kind of audit, work like vouching, casting and posting etc, is dispensed with. This type of audit can be successful in those business houses where efficient system of internal check and control is in operation. This type of audit is popular in U.S.A.

2.13. Occasional Audit :

This type of audit is conducted once a while and that too at the desire of the owner of the business. For example, the audit is not compulsory in case of sole proprietor and partnership business but whenever the need arises the proprietors can get the accounts audited.

2.14. Summary :

Audit is compulsory to certain concerns which is known as statutory audit and it is optional to sole trading concerns and partnership firm, so it is called general audit. Each type of Audit has its own advantages and disadvantages. The type of audit to be adopted depends upon the magnitude of the business.

2.15. Self Assessment questions :

1) Give the objectives of audit of government accounts.
2) What is meant by continuous audit and to what type of business it is specially applicable ?
3) State the merits and demerits of continuous audit.
4) What is periodical audit and what are the advantages and disadvantages of periodical audit.
5) Distinguish continuous audit and periodical audit.
6) Distinguish between an audit under statute and other audits.
7) Write a shortnote on various types of audits and their relative advantages.

2.16. Recommended books :

Principles of Auditing	:	**R.G. Saxene**
Principles & Practices of Auditing	:	**B.N. Tandon**
Principles & Practices of Auditing	:	**Jegadish Prakash**
Contemporary Auditing	:	**Kamal Gupta**

-Dr. Ch. Suravinda

LESSON - 3

AUDIT PROGRAMME

3.0. Object : After going through this lesson the student can know the procedure and planning of Audit. He can also know the procedure of a New Audit.

Structure :

3.1. Introduction :

After having decided as to whether continuous audit or final audit is to be undertaken the auditor should prepare himself for the work. How to proceed with the work will depend upon the circumstances of each particular case. The method of work varies with the training, experiences and knowledge of the auditor.

3.2. Procedure:

As we have already seen that the procedure of audit work will vary from case to case. Some general points are given below.

1. Distinctive ticks of different colours for say additions, postings, ledger balances, carry forwards etc. should be adopted.
2. The significance of these ticks should not be made known to the clerks of the client.
3. The same kind of tick should not be used for the same kind of transactions or for all the visits.
4. As far as possible the work of checking of one book should be completed at one sitting, otherwise some fraudulent alterations may be made by the clerks after the audit clerk has left the office for the day.
5. In every visit the audit clerk should see that there has been no alteration in the work he had already checked on the previous visit. If so, he should get an explanation and check the whole of the work again.
6. If adjustment is found to be necessary that should be carried by passing a journal entry. No alteration of a figure should be allowed.
7. Special ticks should be used for figures which had already been erased.

8. The auditor should write the correct figure with his own ink just close to the erased one and should put a circle around the erased figure with a colour pencil.
9. Sometimes the clients put the total figures with pencil. In such cases the auditor should refuse to commence his work until these figures are inked.
10. The audit clerk should not balance the books. It is not his duty.
11. The audit work should only be started after the client has closed the accounts and final accounts are prepared.
12. No transaction should be passed unless he understands and believe it as true.
13. The auditor should not discuss anything in regard to the meaning of different ticks with the client's staff.

3.3 Preliminary steps:

The audit of accounts of a concern involve sound planning, conduct and judgement. An auditor has to take certain steps before commencing the audit such steps are called preliminary or general steps. They are as follows.

1. He should see that his appointment is in accordance with the provisions of the companies act. If he does not do so he will be held liable. If he has been appointed in place of an other auditor, he should enquire from the retiring auditor the reasons for changes.

V.G. Majundar Vs J.N. Saika 1954:

1. A chartered accountant was appointed by the Directors because the company had failed to appoint the auditors in its annual general meeting. The chartered accountant wrote to the previous auditor of the company about the appointment but finished the work of audit on the same date before the receipt of any reply. It was held that the auditor was guilty, but since it was found that there was misapprehension the auditor was given a warning.
2. He should obtain definite instructions from his clients about the nature and scope of his work and duties whether he has to do the accountancy work or Audit work or both.
3. He should examine the system of accounting employed by his client. If he finds any week points he must study it thoroughly and make recommendations to his client to remove these week points.
4. He should then obtain a list of all books maintained in the office together with the names of the keepers of such books and their specimen signatures, such a list should be duly signed by a responsible official of the company.
5. If internal check system is in operation, he should get a written statement to that effect and should decide whether to rely or not on it.
6. He should get a list of the officers of the company containing particulars about their duties, powers and their specimen signatures.
7. If the business is of a technical nature it would be better to visit the work and acquire technical knowledge to some extent before he actually commences the work.
8. He should ask the clients to balance the books and prepare the final accounts and the Balance

sheet, file the vouchers in the order of occurrence of the transactions, prepare the schedules of the debtors good, doubtful and bad, creditors. Important legal papers, contracts, list of securities etc. If this has not been done so far he should never begin his work until the books have been balanced.

9. He should obtain the previous years audited Balance sheet, if any and see that the accounts during the current year have been opened with those balances which appeared in the previous Balance sheet.

10. He should carefully study all the documents which have a bearing on the accounts. He should study the partnership deed in case of partnership audit. Memorandum and Articles of Association in the case of company audit and trust deed in case of a trust audit.

11. If it is the first audit of a company he must also go through the prospectus, contracts with the vendors, promoters etc.

12. He should get the report of the auditor, if any relating to the accounts of the previous year for information regarding the state of affairs of the company during that year.

13. He should draw up an audit programme.

3.4 Audit Programme:

An audit programme is an essential preliminary to an efficient audit. Hence the auditor should prepare it before the commencement of the audit work. An audit programme is a written scheme of the exact details of the work to be done by the auditor and his staff in connection with a particular audit. It contains the selected periods for tests, dates of work, names of persons performing the work and time taken.

According to Prof. Megis, an audit programme is a detailed plan of the 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.

Audit programme is generally prepared with the columns provided for the name of the clerk doing the work, the type of work the dates when he started and finished the work. Each audit assistant signs for the work, he has performed so that the responsibility may rest upon him for the work he has done.

A specimen of Audit programme is as follows.

SPECIMEN OF AUDIT PROGRAME

Messers ....& Co., Ltd.

YEAR MONTHS	Cash Book	Bank Balance	Cash Book	Petty Cash	-do-	Bought Ledger	Bought Ledger	Sales Book Additions and	Returns Book	Journal	Stock - Sheet	Bought Ledger Balances	Sales Ledger	Trial Balance	General Ledger	Profit & Loss	Balance Sheet	Remarks
JAN.																		
FEB																		
MARCH																		
APRIL																		
MAY																		
JUNE																		
JULY																		
AUGUST																		
SEPT.																		
OCT.																		
NOV.																		
DEC.																		

N.B. : Each audit assistant has to put in his initial in the relevant column after he has checked a particular item.

Advantages of Audit Programme:

The advantages of audit programme may be listed out as follows:

1. It ensures that all necessary work has been done and nothing has been omitted.
2. The auditor is in a position to know about the progress of the work done by his assistants.
3. A uniformity of work can be attained as the same programme will be followed at subsequent audits.
4. Work of the audit can be divided amongst the different juniors who will be responsible for their work. In case a clerk goes on leave, his work can be resumed by another clerk who is in a position to know what work has already been done.
5. It simplifies the allocation of work to various grades of audit clerks.
6. In case of a charge of negligence against the auditor for not having done some work, the auditor can defend himself that the work had been done by him or his assistant who had duly signed the audit programme.
7. It is a kind of guidance to the audit clerk for the work he has to perform. Thus it is a kind of assurance to the auditor that the junior will not overlook essential points while checking the accounts.
8. In case of any fraud or error has remained undetected, the responsibility for negligence can be fixed on the clerk who had performed that work as his initials are put on the audit programme.
9. It facilitates the final review before the report is signed.
10. For a new clerk the audit programme is a guide to his duty.
11. It is a useful basis for planning the programme for the subsequent year.

Disadvantages of Audit programme:

There are however, certain disadvantages of such an Audit programme which may be listed as follows:

1. The audit may become too mechanical in its nature. Audit programme discourages initiative and interests of the assistants.
2. The audit programme even if it is well chalked out may not cover every thing that might come up during the course of audit.
3. New matters of importance arising between one period and an other may be overlooked, if the programme is not kept up to date.
4. Work may be hurried in order to complete a required schedule.

These disadvantages are not quite serious. They can be easily overcome by following certain precautions are as follows:

The auditor should consult the juniors while chalking out a programme. Their suggestions should be appreciated. So that they may not lose initiative. They should be encouraged to make surprise checks outside the audit programme and to recommend additions and improvements in the scheme. As far as possible the audit programme should be made up-to-date on the basis of experience gained and change taking place. In other words great care must be taken to ensure that the programme does not become obsolete. Efforts should thus be made to remove the disadvantages rather than avoiding chalking out the programme itself.

3.5 Audit Note Book:

An audit note book is a book which is maintained by the audit clerk. During the course of audit, the clerk comes across several difficulties or new points which he has to discuss with his senior or the auditor. He notes down these in a book which is called audit note book or Audit memoranda. Every auditor maintains an audit note book for the purpose of making notes of all important matters affecting the audit. The audit note book is of great use to the auditor. It helps the auditor to a great extent in future; specially in subsequent audits of the same concern. If the auditor is charged with negligence in his work, he may produce audit note book as evidence and show the exact work done by him and defend himself from being put in a difficult situation. Thus the audit note book is a documentary evidence in favour of the auditor.

The audit note book should be maintained clearly, completely and systematically. It should not contain the notes of unimportant matters.

The Audit Note Book should be in two parts.

1. for keeping a record of general information as regards the audit as a whole and
2. for recording special points which the audit staff may have come across during the course of audit of the accounts of different years.

An audit note book should contain the following information:

General information:

1. The nature of the business carried on and the important documents relating to the constitution of the business i.e.; Memorandum of Association, Articles of Association and partnership Deed etc.
2. A list of books of accounts in use.
3. Names of principal officers, their duties and responsibilities.
4. Particulars of the accounting and the financial system followed and the internal check in operation in the business.
5. Details regarding accounting and financial policies followed in the business.

Special matters to be recorded in the Audit Note Book:

1. Routine queries not cleared, i.e.; missing receipts and vouchers, etc.
2. The mistakes and errors discovered.
3. The points arising during the course of the audit, to which the attention of the auditor must be draw, i.e.; failure of the company to comply with the provisions of the companies Act or of the Memorandum of Association.

4. Extracts from minutes and contracts etc;
5. The points to be incorporated in the audit report.
6. The points which need further explanation and clarification e.g; a change in the basis of valuation of finished stock or in the computation of depreciation etc;
7. Dates of commencement and completion of the audit.
8. Important matters for future reference.
9. Special points requiring consideration at the time of final accounts.

Audit Note Book should be preserved by the auditor in order to avoid any type of liability which may arise in future. It is also a good reference book for future audit.

3.6. Working papers:

Working papers are those papers which contain essential facts about accounts so that the auditor may not have again to go over the accounts of his client in case he wants to refer to them later on during the course of his audit.

Objects or Aim of working papers:

The objects or Aims of working papers are as follows:

1. In order to support the auditors report these papers show the details of the work performed by the audit clerks.
2. An auditor can form an opinion about the efficiency of the audit clerk, as the working papers remain with the auditor.
3. They are permanent records and therefore in case of any suit against him for negligence, he can defend himself on the basis of these working papers.
4. The preparation of the working papers is a means to give training to the audit clerks as to how to summarise the work done by them.
5. The working papers enable the auditor to point out to the client the weaknesses of the internal control system in operation.
6. The working papers help the auditor to plan for the succeeding year.
7. It will enable the auditor to prepare the report without much waste of time.
8. He can know that his assistants had followed his instruction.

Working papers should be carefully prepared as they are the basis of conclusions and summarisations shown by the auditor in his report. They should be clear, complete and contain all essential information in regard to accounts and audit so that they may be of maximum utility. They should be properly organised and arranged so that one may not find difficulty in pin-pointing a particular matter.

8.A Essentials of good working papers:

1. The working papers should contain all the essential information so that they may be of maximum utility.

2. The working paper should be so arranged that one may not find any difficulty in locating a particular matter. If they are not properly arranged it will result in loss of time in finding a particular fact while preparing the report.
3. The facts in the working papers should be set out clearly.
4. The facts stated should be readily available to the reader later on.
5. Paper used for working papers should be of good quality so that by frequent handling it may not be damaged.
6. Paper used should be of convenient and uniform size.
7. Sufficient space should be left after each note so that any decision taken by the auditor may be taken down in that space.
8. Papers should be arranged in a logical order.

Preservation and filing of working papers:

It is necessary that the working papers should be preserved as they are important and valuable documents for the clients as well as for the auditor. It is therefore suggested that they should be filed systematically. For convenience, the working papers may be sub-divided between current and permanent files.

The current files should normally include the following documents

a) A copy of the accounts under review.
b) The audit programme and audit tests performed.
c) Minutes book of the directors and share-holders meetings or the board of trustees or partners.
d) Queries raised during the audit and the official comments.
e) Letters from clients and other sources confirming account, certificate for valuation of stock and provision for bad debts, etc.
f) A list of missing vouchers.
g) Bank and branch reconciliation statements.
h) Computation of tax, bonus and gratuity etc.

The permanent file should normally include following documents.

a) A copy of the memorandum of association and articles of association, partnership deed and trust deed etc.
b) A copy of the relevant statutory regulation.
c) A brief note on the nature of the business.
d) A copy of the letter containing client’s instructions as to the work to be performed.
e) A list of important books maintained by the client.

f) A list of officials with the nature of work performed by them and a copy of the organizational chart.

g) A short description of the system of internal control and internal audit in operation.

h) Statements setting out the basis of stock valuation and computation of depreciation etc.

3.7. Summary :

The procedure of audit work will vary from case to case. The audit of accounts of a concern involve sound planning conduct and judgement The steps which the auditor take before commencing the audit are called preliminary or general steps. The auditor should chalk out a programme before commencement of the audit work. It is a written scheme of the exact details of the work to be done by the auditor and his staff in connection with a particular audit.

During the course of audit, each audit clerk maintain a book to note points which he has to discuss with his senior or the auditor. This book is known as Audit note book.

The auditor, while auditing the accounts prepare certain papers which contain essential facts about accounts which will help to prepare his report without much difficulty. These papers also will be filed for future use.

3.8. Self Assessment questions:

1. What is an audit programme? and what are its objects ?
2. What steps an auditor should take before commencing a new audit ?
3. What is an "Audit note book" ?
4. Describe an Audit note book. What are its contents and its value to an auditor ?

3.9. Recommended books

Principles of Auditing	**:**	**R.G. Saxene**
Principles & Practices of Auditing	**:**	**B.N. Tandon**
Principles & Practices of Auditing	**:**	**Jegadish Prakash**
Contemporary Auditing	**:**	**Kamal Gupta**

Dr. Ch. Suravinda

LESSON - 4

INTERNAL CHECK

4.0. Object : After going through this lesson the student can know what is internal check ? What are its advantages ? How can the work of internal check is drafted in case of cash receipts and payments, purchases, sales, wages etc.

Structure :

4.1. Introduction :

Internal check is a method of organising the accounts system of a business concern or a factory where the duties of different clerks are arranged in such a way that the work of one person is automatically checked by another and thus the possibility of fraud or error is minimised unless there is a collusion between the clerks; e.g; the receipt of cash is entered by the cashier on the debit side of the cash book, this entry is carried to the ledger by another clerk, the statement of account relating to this transaction is sent to the customer by a third clerk and so on. It is a kind of division of labour. This minimises the possibilities of frauds and errors unless all the three join hands in defrauding their employer. The secret among three will be a secret for all is true in this case.

4.2. Definition :

F.R.M. De Paula defines it as "Internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently, checked by other members of the staff".

L.R. Dicksee, defines internal check as "Such is arrangement of book-keeping routine that errors and frauds are likely to be prevented or discovered by the very operation of the book - keeping itself."

American Institute of Accountants, 1949, defined internal check as "Internal check- 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 that on the contrary, the work of one employee is complementary to that of an another and that a continuous audit of the business is made by employees".

Thus the system is based on the principle of division of labour that is the work in the organisation, is arranged in such a way that the work performed by one individual is checked by another automatically.

4.3. Objects of Internal Check :

The internal check system is organised to achieve the following objects:

1) To prevent the commission of any error or fraud by a clerk.
2) To prevent the misappropriation of cash or goods by any clerk by keeping a check on the receipts and payments of cash and receipts and delivery of the goods.
3) To throw responsibility on a particular clerk when the fraud or mistake is detected.
4) To detect a fraud or an error quickly and easily.
5) To have an accurate record of all business transactions.

4.4. Essentials of good Internal check System:

The following points are to be taken into consideration in framing a good system of internal check.

1) No single person should have an independent control over any important aspect of business for ex ; When goods are purchased on credit, entries are made in the purchase book by the gate-keeper he enters the name of the supplier, the quantity of goods and the date on which they are received; another entry is by the keeper of the purchase book, in the purchases book. Thus, the same staff by different clerks and the possible of fraud or mistake is reduced to a transaction is entered.
2) The duties of the members of the great extent be changed from time to time without prior notice.
3) Every member of the staff should be instructed to go on leave at least once. This will help in detecting the conceal frauds.
4) Persons having physical custody of assets must not be permitted to have access to book of accounts.

5) To prevent misappropriaton of cash, mechanical devices should be employed.

6) Procedures should be laid down for the verification and testing of different sections of accounting records periodically, to ensure their accuracy.

7) The financial and administrative powers should be assigned to different officers.

8) For stock taking at the close of the year, the trading activities should be suspended for some time. The task of pricing and evaluation of stock should be done by the staff other than that of stock section.

9) No member of the staff should be allowed to take away goods without prior permission of some responsible official.

10) There should be efficient accounting control in respect of each important class of assets.

11) Ledger keepers should not be allowed to have a direct access to either the debtlors or creditors of the business.

12) A detailed record should be maintained for all goods received and sent out of the business premises.

4.5. Auditor's duty in regard to Internal check system :

To what extend should an auditor depend upon the internal check system will depend upon the magnitude of the business whose accounts he is auditing.

In the case of a concern where there is no internal check system and the clerk has full control over all the books of accounts. It would be better if the auditor should check all the transactions from the beginning to the end irrespective of the fact whether the concern is small or big.

In the case of concern where there is a good internal check system, the auditor, may rely upon it to a great extent. But he must not be negligent. He should apply a few test checks. The existence of a good internal check system reduces to a great extent the work of the auditor but does not reduce his liability. To what extent should an auditor depend upon the internal check system will depend upon the circumstances of each particular case and the efficiency of his audit will depend upon his tact, skill, experience and judgement.

4.5. Internal control :

Control is a wider term and will include all types of management controls. It is a means of assisting modern business management in discharging its function. The term internal control has been defined as "the whole system of controls, financial or otherwise established by the management in order to carry on the business of the company in an orderly manner safe guard its assets and secure as far as possible the accuracy and reliability of its record." According to this definition, internal control means a/. accounting control b/. operation controls i.e.; quality control, budgetary control, internal checks and internal audit etc.

a) Accounting controls :

Comprise primarily "the plan of organisation and the procedures and records that are concerned with and directly related to the safeguarding of assets and reliability of financial records."

Accounting and financial control include budgetery control, standard costing, self balancing ledgers and internal auditing etc. such controls ensure accuracy and reliability of financial records

b) Administrative controls :

Comprise the plans of organisation that are concerned mainly with operational efficiency. They may include controls, such as time and motion studies , quality control through inspection, performance reports and statistical analysis.

4.7. Internal control and the Auditor :

From the definition given above, that it is the responsibility of the management to instal internal control in order to carry on business of the company in an orderly manner. The institute of Chartered Accountants of India also stated the duty of safeguarding the assets of a company is primarily that of the management and the auditor is entitled to rely upon the safeguards and internal controls instituted by the management. Therefore an auditor is mainly concerned with the evaluation of the internal control system in force so that he may be able to know.. Certain things which may be listed out as follows.

1) whether mistakes, errors and frauds are likely to be located in the ordinary course of operation of the business;

2) whether an efficient internal auditing department exists or not;

3) how far the management is discharging its function in regarding to correct recording of the transactions;

4) how extensive examination he should carry out in the different areas of accounting;

5) how far administrative control has a bearing on his work;

6) What should be the appropriate audit programme in existing circumstances;

7) to what extent he can depend on the records and reports of the management.

If the auditor does not acquaint himself fully with the internal control system and its actual operations he cannot formulate a satisfactory audit programme.

4.8. Internal Audit :

Internal Audit is the review of operations and records under taken within a business by specially assigned staff. The term internal audit has been defined as "the independent appraisal of activity within and organisation for the review of accounting, financial and other business practices as a protective and constructive arm of management". From this definition it is clear that internal audit not only includes the verification of accounting matters but also financial and other matters.

The work of the internal auditor is more or less the same as that of an external auditor. Being the employee of the organisation he has to see that there is no waste and inefficiency in the organisaiton. He has to find out weakness of the internal control and internal check systems followed in the organisation and suggest necessary improvement. Internal auditor assist management in achieving the most efficient administration of the organisation.

Differences between internal Auditor and Independent Auditor.

Internal Auditor	Independent Auditor
1) He is an employee of the concern. His duties, rights and responsibilities regarding audit work are determined by the management.	1) He is appointed under statute and his scope of work and liability etc are laid down by the statute.
2) Internal auditor is appointed by the management.	2) He is appointed by the shareholders or by the Government.
3) It is optional to appoint an internal auditor.	3) It is compulsory.
4) He need not be a qualified auditor.	4) He must satisfy the qualifications mentioned in companies Act.
5) He presents accounting information to the management continuously to take policy decisions.	5) He ensure the shareholders that the financial statements show a true and fair view of the financial position of the company.
6) He has to submit his report to the management.	6) He submits his report to the shareholders through the management.
7) His work is continuous in nature.	7) His work is periodical in nature.

4.9. Internal check as regards cash receipts

There are lot of chances of misappropriation of cash if there is no well organised system of Internal check. He should enquire as to the duties of the cashier and whether he has access to the ledger and other books of original entry. If it is so, there are chances of fraud and therefore he should be vigilant. The following steps of internal check as regards receipts is suggested.

1) When cash is received, it should be acknowledged by means of a printed receipt which should have a counterfoil or by a carbon copy. Cashier should not sign receipts and counter foils. The receipts should be consecutively numbered. The unused receipt book should be kept under lock and key. Spoiled receipts should be cancelled and must not be detached from the counterfoils. No blank counterfoils should be accepted.

2) As soon as cash is received it should be entered in a rough cash book or diary

3) Remittances should be opened by the cashier in the presence of a responsible officer who should not be connected with the cashier's office. All cheques received should be crossed.

4) All the receipts of the day should be deposited in the bank at the end of the day or the next morning.

5) Bank recociliaton statement should be prepared frequently by the cashier and also by some

one else.

6) The cashier should not have any control over the ledgers.

7) Petty cash should be organised under the imprest system.

8) Before a cheque is issued it should be presented along with the account of the payee, to a responsible officer who should not have any access to accounting records or securities for his signature. Unused cheque book should be kept under lock and key by a responsible official.

9) Castings of the cash book should be independently checked.

10) Internal control over the preparation of wage sheets to prevent fraud and manipulation should be exercised.

11) All payments as far as possible except for petty cash, should be made by cheques.

12) If travellers are permitted to collect money on behalf of the company, the issue of receipts by them and deposits of such money into the bank should be carefully controlled. As far as possible the system of collection by the travellers should be discouraged. The travellers should be given receipt books having three copies -one to be given to the customer, another to be sent to the head office and the third to be retained by them.

13) Cashier should not sanction the payments of special nature. Directors should do so.

4.10. Internal check as regards cash payments :

1) All payments should be through crossed cheques.

2) Petty cash payments should be handled by the petty cashier. This books should be maintained under imprest system.

3) For all payments made vouchers should be checked with relevant vouchers.

4) All cheques and bills should be thoroughly checked and signed by the proper authority.

5) Confirmation of accounts with the creditors should be made to maintain up-to-date records.

6) All vouchers should be serially filed.

7) Bank reconciliation statement should be prepared frequently.

4.11. Internal check as regards sales :

In big business concerns a separate department to deal with sales is kept. This is under the supervision of a responsible official known as sales manager. Following procedures should be adopted to control sales :

1) Whenever an order is received, it should be recorded in the order received book, giving details regarding the date on which the order was received, the name of the customer, the particulars about the goods, date of delivery mode of transport etc.,

2) The copy of the order is sent to the Despatch Department.

3) When the Despatch Department has packed the goods, another clerk should compare the

goods so despatched with the order to see that the whole of the order is complied with or another list is prepared showing the goods in the package which list is sent to the counting house.

4) A responsible official will now mark the rate at which the goods are to be charged.

5) A clerk will make the calculations.

6) The outward invoice is then prepared in duplicate.

7) One copy of the invoice will be sent to the invoice clerk who enters, it in the sales book and later on this is sent to the customer, another copy will be sent to the gate-keeper who will record in the goods outward book the third copy is filed for further reference.

8) If orders are received through the travellers, they should be given order books with tripicate copies - one copy to be handed over to the customer, the second to be sent to the Head office and the third one is to be retained by the traveller for his record.

The Duties of Auditor in connection with credit sales :

1) He should see that whether the internal check system in operation is efficient or not. If it is not so, he should disown his responsibility. If it is efficient, he should apply a few test checks.

2) He should compare the data of invoices with the data in sales book.

3) He should see that the sale of an asset is not treated as ordinary sale.

4) With the permission of the client, the auditor should send statements of Accounts to the customers to confirm the accuracy of the balance.

5) He should check the sales book for the last days or weeks of the financial period and the returns. Inward book for a few days or weeks after the close of the period in order to see whether fictitious sales or returns has been recorded to inflate profits.

6) He should check the casts of the sales Book.

7) The cancelled invoices, if any, should be checked with the duplicate copy of the invoice.

8) Sales tax, insurance charges etc., which are recoverable from the customers should be debited to the customer's account.

9) Sales to allied or sister concerns should be carefully examined as they may be fictious.

10) If there is a significant difference of trade discount allowed to two different purchasers, he should inquire into the reasons of such a distinction.

Sales Returns :

When the goods are returned from customers, defective or an account of any other reason, they should be entered by the gate keeper in the register known as gate-keeper's Returns Inward Book and the Stock Register. The goods returned should also be recorded in the sales returns book and a credit note should be prepared to be sent to the customers. Such a credit note should be signed by a responsible official. There are lot of chances of fraud in connection with the sales returns e.g:

The goods might not have been returned but a credit note has been sent to the customer. The auditor should, therefore, pay particular attention to such transactions.

Sometimes the customers attempt to return the goods if there is a fall in the prices after the purchase has been made. The auditor should pay attention to such a return of goods. Return from allied or sister concerns should be carefully examined to see their genuineness. The auditor should vouch these transactions with the gate - keeper's Returns Inward Book and with the carbon copies of the credit notes sent to customer or, the debit note received from the customers. He should see that returns just before the date of balancing the books are recorded both in the stock as well as in the Sales Returns Book. If they are taken into stock, but are not entered in the Sales Returns Book, result in hike in profits

Goods sold on sale-or return system :

Sometimes goods are sold to customers on approval i.e., the goods are delivered to customer on condiiton that if he does not approve of the goods, he can return them within a particular period. Until the customer approves the goods they cannot be treated as sales. The auditor should, see that until the approval, such goods must be shown as goods with customers and deducted from sales of the current period and from the list of the debtors.

Goods sent on consignment :

When the goods are sent out to agents to be sold at the owner's risk, a separate book called 'cosignment outward journal; should be maintained if the number of such transactions is large. This book should be vouched with the copies of the proforma invoice, account sales and contracts with consignees. The unsold goods with consignees should not be treated as sales but should be shown in the balance sheet as 'goods on consignment'.

4.12. Internal check as regards Purchases :

A big business concern should have a separate purchase department in order to have proper and effective control over purchases.

The department requiring supplies or assets, must send requistion to the purchase department. These requistion must be prepared in duplicate. The details about the quantity, quality and the time by which the goods must be supplied should be clearly stated in the requistion slip.

The purchase department after searching the best vendor or supplier will prepare four copies of the purchase orders. One copy will be sent to the vendor, second to the stores and third will be forwarded to the accounting department. The purchase order should be carefully written and must be approved and authorised by the head of the purchase department or officer authorised to do this work.

In receipt of goods, the purchase department should properly inspect them and must compare with the purchase order. Goods received should also be entered in the goods Inwards Books. The purchase department then send the goods to the stores and will also inform the concerned department about the receipt of the goods.

After a thorough check these invoices should be sent to the accounting department for payment. The accounting department should compare the invoice with the purchase order and the inspection report of the purchase department and should also verify the calculations. If found correct a record must be made in the purchases book. Payment of the verified invoices should be authorised by a senior officer. If some portion of the goods are returned to the supplier, proper entry must be made in the Purchases Return Book. A credit note to that effect must be obtained from the supplier and the accounts section must be informed accordingly.

4.13. Internal check as regards wages :

There are many chances of misappropriation of cash under this head. The chances of fraud or errors are there by inclusion of fictitious names of dummy or ghost workers in the wages book ? Over-stating of rates of wages, over-stating of hours of work or days of work put in by the workers etc. All these may mean withdrawal of more money than is actually needed for payment to the workers.

The following internal check for the payment of wages is however, suggested to avoid fraud.

Workers are paid their wages normally on the basis of the time spent by them. Therefore the time spent by each worker should be correctly recorded in the time record books. Each worker is provided with a time card. He should punch his card at the time of arrival and departure from the place of his work.

The purchasing of card must be supervised by the time keeper. In addition to strengthen the internal check system, the foreman of each department should be asked to keep the records of the time of his employees. At the end of the day the time-keeper and foreman should separately prepare the time records and the name of absentees.

If the workers are paid on the basis of piece - wages system, the proper books for recording the actual work done by workers should be maintained. A job card should be given to each such worker. The actual work done by a worker should be recorded on this card which should be counter signed by the foreman of the department as well as by the store helper to whom the goods produced are to be delivered. The quality of the work and job card should be finally checked by the piece-work-reviewer.

Sometimes workers are allowed to work overtime. In such cases overtime slips must be issued to such workers by the properly authorised official. No worker should be allowed to work overtime unless he is authorised to do so by the authorised officials of the organisation.

The preparation of wages sheets should be done by a separate department. This work should be done at least by four clerks, so that irregularities may be minimised. For time workers and piece workers separate wage sheets must be used. All the clerks who delt with wage sheets should initial the wage sheets before they are signed by the works manager.

The payment of wages must be made by a person who is in no way concerned with the preparation of wage sheets. The cashier should with draw the net amount as shown by the wage sheets. Wages should be paid to the workers personally. The foreman of each department should be present at the time of payment to identify the workers of his section. If possible the signatures of the workers must be obtained when they receive the amount of wages, cashier foreman or works manager should attest these statements. Wages may be handed over to the fellow worker only if he is authorised in writing by the absentee worker. A list of unpaid workers should be prepared by the cashier and the foreman of the department. If casual workers are also employed in the organisation, a list of such workers must be prepared by the foreman of each department. A surprise visit of a senior official while the wages are disbursed will be an effective measure of control.

4.14. Internal check as regards stores :

To preserve finished goods and raw materials a store is essential. To prevent pilferage and misuse proper control of stores is necessary. The following points may be of great help for effective control of stores.

1) Store should be located at a convenient place.
2) Goods received in the store must be entered into goods received sheets. These sheets should be prepared in triplicate - one for the purchase section, second for accounts section and the third copy to be retained in the store.
3) Goods received should be stored at their allotted racks.
4) The system of bin cards should be used to show the receipts, issues and balances of stores.
5) Stock - taking should be carried out at regular intervals.
6) Storekeeper should issue the goods only against proper, approved and authorised requisition.
7) A gate pass should be given to authorised persons who will take out the goods from the store.
8) When materials are returned from the job or by some department a "Material Returned Note" should be prepared.

4.14. Test check :

In those business houses where a satisfactory and effective system of internal check is in operation, it is not necessary for the auditor to do detailed checking. The usual practice is that a certain number of entries of each class is selected and checked and if they are found correct, the remaining entries are also taken to be correct. This is known as "Test checking". The selection of items and the extent of test checking would mainly depend upon the auditor's judgement and assessment of a particular situation.

Test checking can be of immense help to the auditor as it will reduce his work and he can devote his time to the more important sections of the work. But it should be kept in mind that test checking does not relieve an auditor from his liability if in future mistakes are detected. In applying test checks in auditing the following precautions must be taken.

1) Entries selected for test checking should be representative.
2) Selection of items to be checked should be at random.
3) A number of entries for the first and the last month of the period covered by the accounts should be checked.
4) Cash book should be thoroughly checked. Test check should not be applied to cash book.

5) Periods and entries selected for test check should be different at each audit.

6) The auditor should always change the methods of test checking.

7) The method of test checking should be kept secret from client's staff.

Advantages of test checking :

1) The volume of work is reduced. It saves time.

2) There is a moral check on the clients staff as they do not know the period or portion of work which will be taken up for test checking.

Limitations :

There are few limitations of test checking. Since test checking is based on the selection of the representative items, it is always possible that some of the errors or frauds remain undetected. Secondly the client's staff may become careless because they know that their work will not be checked in detail by the auditor.

4.16. Summary :

Internal check is a kind of division of labour. This minimises the possibilities of frauds and errors. It throw responsibility on a particular clerk when the fraud or mistake is detected. Internal control involves all types of management controls. Internal audit is carried by the staff to review the operations and records undertaken within the business. The system of internal check adopted to each type of transaction is different from other. To avoid a detailed checking of each and every transactions, the method of test checking may be adopted by the auditor if there is an efficient system of internal check in the concern.

4.17. Self Assessment questions :

1) What is meant by the term internal check ?

2) What are the objects of internal check ?

3) Prescribe the system of internal check for sales, purchases, wages.

4) Distinguish between internal check, Internal control and internal audit.

5) What should be a good system of internal check as regards cash receipts and payments.

6) What is test check ?

4.18. Recommended Books

Principles of Auditing	:	**R.G. Saxene**
Principles & Practices of Auditing	:	**B.N. Tandon**
Principles & Practices of Auditing	:	**Jegadish Prakash**
Contemporary Auditing	:	**Kamal Gupta**

- Dr. Ch. Suravinda

LESSON - 5

VOUCHING

5.0. Object : After going through this lesson the student can know what is vouching ? How the Auditor vouch the cash transactions and trade transactions.

Structure :

5.1. Introduction
5.2. Definition
5.3. Importance of vouching.
5.4. Points to be noted while vouching.
5.5. Vouching of cash transactions.
5.6. Vouching the Debit side of cash book.
5.7. Vouching the credit side of cash book
5.8. Vouching of Trading transactions
5.9. Purchases book - purchase returns book.
5.10.Sales book - Sales returns book
5.11. Summary
5.12. Model questions
5.13. Reference books.

5.1. Introduction :

Examination of the documentary evidence in order to ascertain the accuracy and authenticity of entries in the accounts books is called "Vouching". Vouching is a technical term which refers to the inspection by the auditor of documentary evidence supporting and substantiation a transaction. Vouching means a careful examination of all original evidences i.e., invoices, statements, receipts, correspondence, minutes and contracts etc. With a view to ascertain the accuracy of the entries in the books of accounts and also to find out, as far as possible, that no entries have been omitted in the books of accounts.

5.2. Definition :

According to Dicksee : "Vouching consists of comparing entries in the books of accounts with documentary evidence in support thereof".

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

From all these definitions it is clear that vouching means testing the truth of entries appearing in the primary books of accounts.

5.3. Importance of vouching :

Vouching is the essence of auditing. Success of an audit will depend upon the thoroughness with which vouching is completed. It is an important tool in the hands of an auditor and the success of an auditor in vouching depends upon his intelligence, commonsense, observation and tact with which he handles his work. An auditor should not merely check the arithmetical accuracy of the books or compare the entries with the available documentary evidence but he should go to the source of a transaction. If he simply compares the entry, say, on the credit side of a cash book with the voucher, it is possible that he might be deceived e.g; the purchase might not have been for the business or the receipt might have been for the previous year.

5.4. Voucher : Points to be noted while vouching :

A voucher is a documentary evidence in support of a transaction in the books of account. It may be a receipt, counterfoil of a receipt book, an agreement, resolution passed by the Board of Directors or shareholders, an invoice, bank paying in-slip. Bought note, sold note, correspondence, gate keeper's books, wages book, order book and so on.

While examining the vouchers, following points must be born in mind :

1) All the vouchers are consecutively numbered and filed in order of the entries in the accounts. If the client has not done so, the auditor has a right to ask him to do so. If they are not properly arranged, much valuable time will be lost in finding out a particular voucher to check it.

2) He should pay attention to the dates which must correspond with the cash book, name of the party to whom the voucher is issued the name of the party issuing the voucher and the amount etc.

3) The voucher inspected should be cancelled by a stamp. In case stamp is not available the audit clerk should affix his initials or put a tick right across the face of the voucher. Such a mark of stamp should be put in the centre of the voucher to avoid its removal by a dishonest clerk.

4) Special attention should be paid to those vouchers which are in the personal name of one of the partners, directors, or secretary etc. In such a case original invoice, goods inward book should be examined to find out whether the goods were purchased for the business or not. He should ask his client to issue instructions to the suppliers not to address the vouchers to any individual of the firm or the company.

5) He should see that every voucher is passed as order by a responsible officer.

6) He should also note whether the voucher is stamped if the amount of the voucher is above twenty rupees.

7) He should also find out the nature of payment as to whether it relates to the business.

8) He should see the nature of payment whether capital or revenue. This is important as wrong posting will effect the profit and loss account and ultimately the Balance sheet.

9) Attention should be paid to the amount both in words and figures. If they differ the, matter should be investigated.

10) Note should be made of any item which requires further elucidation or information or evidence which is available from partnership deed, contracts, Articles of Association etc.

11) If duplicate voucher for a missing one is produced it should be properly scrutinised to avoid any fraud. Reasons and explanation for their loss should be obtained from the client and if the auditor is not satisfied with the explanation, he should mention this fact in his report.

12) The audit clerk should not take the help of any members of the staff of the client.

13) Receipted invoice should not be accepted as a voucher because there is a danger of the payment being made twice. Once as a credit purchase and again as a cash transaction against the receipted invoice.

14) Sometimes business houses issue their own printed receipts which are considered as vouchers, in such a case the auditor should get more documentary evidence such as statement or invoice.

15) While examining the vouchers for insurance, rent, rates, taxes etc, the audit clerk should note the period for which the payment has been made. If the payment is made for some months in advance, proper adjustments should be made.

5.5. Vouching of cash transactions :

The auditor after satisfying himself that there is a good internal check system regarding the receipts and payments of cash, the audit clerk should now proceed to vouch the cash book.

5.6. Vouching the Debit side of cash book :

The following are the items appear on the debit side of the cash book.

1. Opening balance :

This should be compared with the balance shown in the duly audited balance sheet of the previous year. This is done to see that the actual balance has been brought down.

2. Cash sales :

There are greater chances of fraud under this head. The salesman may sell goods and may not make an entry in the cash book and thus misappropriate the money. The following system should be avoided to avoid fraud. The sales man should neither deliver the goods to the customers nor receive cash for the goods sold. At the end of the day the salesman, the cashier and the gate keeper prepare the summaries and send them to the general manager. All the three summaries must tally. The auditor should check here and there a few items from the sales man's summaries, cashier's summaries and the gate keepers extracts. If the auditor does not do so; he will be held liable for any fraud which remained undetected as was decided in the case of Pendel bury's Ltd. Vs Ellis Green & Co in 1936.

The auditor should also compare the dates on the cash memos and the cash book. If cash discount has been allowed on sales, he should see a uniform policy and rate of discount has been followed.

3. Receipts from Debtors :

The auditor should vouch cash received from debtors to whom goods has been sold on credit in the past. The only evidence available on account of this item is the counterfoils of the receipts issued to the debtors. But this evidence is not very reliable as less amount might have been inserted in the counter foils than what had actually been received from the customer. Another method of committing fraud is when cash is received say from 'A' no entry is made in the cash book. Later on when cash is received from 'B' the amount is recorded on the debit side of the cash book by crediting the account of 'A', again when money is received from 'C' the amount is credited to 'B' and so on.

The auditor should pay attention to the following in order to check such a fraud. He should check the cash book with the rough cash book and the counter foils of the paying in slips. Particular attention should be paid to discount allowed to customers. The method of granting discount should be enquired. In case a debt is written off as bad the auditor should enquire as to who is responsible to write off debts as bad. Where ever possible after taking permission from his clients a statement of accounts should be sent to the debtors to confirm the balances and also debtors be instructed to send letters of confirmation direct to the auditor

4. Income from interests Dividends etc :

Interest received on account of fixed deposits in the bank should be vouched with the bank pass book. Dividends received can be vouched with the counter foil of 'tops' of dividend warrants or the letter covering the cheque. Where dividend and interest are collected through bank, pass book must be verified. Care should be taken to adjust the outstanding interest. Interest received from any particular fund like providend fund should be credited to that fund and not to the revenue account. If the interest has been received on account of the loan granted. Agreement with the borrower should be inspected to ascertain the rate of interest.

5. Loans :

The receipt of loan should be vouched with the agreement with the ledger, He should see whether his client is entitled to raise loans. He should examine the rate of interest payable, the terms of repayment and the securities offered.

6. Rents Received:

The auditor should examine the lease deeds and agreements to ascertain the amount of rent payable, the due date and provision regarding the repairs etc., If receipts are issued to the tenents for the rent paid, the counterfoils of the receipts would be a good evidence. Particular attention should be paid towards rent outstanding. If the outstanding is heavy one, with the permission of the client the auditor should write to the tenents requesting them to confirm the amount of arrears of rent outstanding against their names and also, the auditor should get a list of unlet property duly signed by a responsible official.

7. Bills Receivable :

The auditor should examine the entries in the Bills Receivable Book. He must compare these items with the entries in the cash book for all the bills matured. In respect of those bills which have been discounted before maturity the Bills Discounted Book should be checked. He should also see that all the records have been properly made in the books related to discounts, dishonour or retirement of all bills.

8. Commission :

Commission account should be checked with the accounts of the parties from whom commission has been received. Agreement with the parties regarding the rate of commission should be inspected.

9. Sale of Investments :

The amount received on account of the sale of investments should be vouched with the brokers sold note.

10. Bad debts Dividend :

The amount received from debtors, who have become bankrupt should be vouched with the dividend warrants received from the official receiver indicating the total debt and rate per rupee payable as dividend and the number of instalments.

11. Subscriptions received by a club or school etc.; should be checked with the register of subscribers and the counter foils of the receipts.

12. Insurance claim money :

Insurance money received against a claim from an insurance company should be checked from correspondence passing between the client and Insurance company.

13. Sale of fixed assets :

This item may be vouched with correspondence auctioneers account, sale of contract etc. If there is any profit that should be credited to the capital reserve account which is not available for distribution to the shareholders. The auditor should also see that the sale of such property has been properly sanctioned.

14. Income from hire purchase agreement :

Where money is received on account of the instalment relating to goods sold on hire purchase system. The auditor should examine the agreement. The auditor must also see that proper allocation between sales and interest had been done.

5.7. Vouching of credit side of the cash book :

The auditor should see that the payments have been actually made to the right person or party and also whether the payment is for the business itself and have been sanctioned by a person holding some authority and have properly recorded in the books of account.

1) Payments to creditors :

Money paid to the creditors can be vouched with the receipts issued by the creditors acknowledging the receipt of money. The auditor should enquire whether periodical statements are submitted by the creditors and are compared with the creditors accounts. In regard to cash purchases, cash memos and goods inward book should be compared with the entries in the cash book.

2) Wages :

Another important entry which is usually a big one is that of wages. Before the auditor proceeds with his work, he should make a through investigation regarding the internal check system which is in operation. If he finds any loophole he should probe into it and disown his responsibility. He should check the casts of the wage sheets and wages book. He should check the total amount of wages payable with the amount of cheques drawn to see that more money has not been with drawn than was needed. He should check the names of some of the workers mentioned in the wages sheets with the cards and the gatekeepers and the foreman's register to see that no dummy workers are included. He should also see that the wages sheets are properly signed by all the persons responsible for the preparation of the wages sheets. The number of workers as recorded in the wages sheets should be compared with the employees state insurance cards. Wages sheets of the previous months should be compared with the current month and if there is any increase, enquiry must be made. He must compare the signatures of the workers of two or three periods. In short the duty of an auditor in verifying the items of wages sheets. The number of workers as recorded in the wages sheets should be compared with the employees state insurance cards. Wages sheets of the previous months should be compared with the current month and if there is any increase, enquiry must be made. He must compare the signatures of the workers of two or three periods. In short the duty of an auditor in verifying the items of wages is to see that the wages as recorded in the cash book have actually been paid and that they were actually due and that they were properly authorised.

3. Loans :

He should examine the receipt given by the borrower and the loan agreement, promote or Bills of exchange. He should make enquiry whether his client is authorised to advance loans. In case of loan to the directors, managing agents he must see that the provisions of the companies act are satisfied. (Sec 295, 369 & 370).

4. Salaries :

Salaries book should be examined. He should see that the total of the salaries book for a particular month agrees with the cheque drawn for salaries. He should see that necessary deductions for providend fund, Income tax etc have been made. Salaries may be verified with the annual returns submitted to the income tax Department regarding the payment of salaries.

5. Agents and Travellers Commission :

The agreement with travellers and the agents should be examined to ascertain the terms of the appointment regarding the rate of commission. The auditor should test the payment of commission by examining the order received through the travellers.

6. Travelling allowances :

He should see the rules and regulations regarding the payment of travelling allowances. Calculations should be made. An extraordinary travelling expenses should be authorised by the Board of Directors. Where fixed travelling expenses are allowed, no calculations are necessary. He should see that the travelling bills have been duly checked by a responsible official.

7. Insurance premium :

In case of a new policy, the covering note or the receipt from the Insurance company and the policy itself should be checked. In case of a renewal the renewal receipt for the premium should be examined.

8. Bills payable :

Returned bills duly cancelled should be examined. It would be a sufficient evidence of the amount having been paid.

9. Bills receivable discounted and dishonoured :

Bills Receivable which has been discounted with the bank and which have been dishonoured can be vouched with the entry in the bank pass book. The auditor should see that the account of the acceptor is debited with the amount of bill and noting charges.

10. Freight, carriages and customs duty :

The statements of account regarding the payment of freight and carriage submitted by the suppliers clearing forwarding agents should be examined to see that the payment has been duly made and accounted for.

11. Bank charges :

Bank Charges such as commission, interest on over draft and loans etc., should be examined with the Bank Pass Book.

12. Partners Drawings :

Partnership deed should be examined as to what is the maximum amount and the time for which a partner can draw money and whether he is to be charged any interest on drawings. He should vouch this entry with the partners drawings book or account and see that the signature of the partner is there against such entry.

13. Petty Cash :

There are greater chances of misappropriation of cash as there are no vouchers for a number of petty expenses. He should therefore make an enquiry into the internal check system of petty cash payments. The petty cash book should be maintained on the imprest system. He should insist upon having vouchers for every expenditure say above Rs.20 or so. In case where getting voucher is not possible then docket system should be introduced. The counting of petty cash balances in hand is very important. If he does not do so and if there is any discrepancy in the balance as per the petty cash book and actual cash in hand. He will be held responsible to pay damages as was held in the case of London oil storage Co. Vs Sear Hasluck & Co.

14. Directors Fees :

As a general rule the directors of a company can not claim any remuneration unless the Articles expressly provide for it. According to [See 211 (2)] of the companies Act, the remuneration paid to the directors either by way of fees or commission etc., must be shown separately in the profit & loss A/c. If this has not been done the auditor must make a mention of this fact in his report.

15. Vouching of cash sales :

At first the auditor has go through the system of Internal Check followed by the concern. If he satisfied with the system of internal check employed in the concern, the auditor should check here and there a few items from the sales man's summaries, cashiers summaries and the gate keeper's extracts. If the auditor does not do so, he will be held liable for any fraud which remained undetected as was decided in the case of Pendle Bury's Ltd Vs Ellis Green & Co in 1936. The auditor should compare the dates on the cash memos and the cash book. If discount has been allowed on sales he should see that a uniform policy and rate of discount has been followed. The cancelled cash memo should not be detached from the book. He may also compare a few items of sales with the stock register.

5.8. Vouching of Trading transactions :

After completing the vouching of cash book, the auditor may now proceed to the audit of the trading transactions.

Here the auditor is concerned with the checking of the purchases book and the sales book. The main object of vouching these two books is to check and prevent misappropriation of goods. The auditor should see that his client pays only for those goods which are received by him. Therefore, the auditor should carry out the audit of these books very carefully and intelligently.

5.9. Purchases Book – Purchases Returns book :

Purchases Book :

After having satisfied himself that there is a good internal check system regarding the purchases, the auditor should now proceed to vouch the purchases book. Entries in the purchases book should be vouched with the invoices relating to the purchases and the goods inward book maintained by the gate keeper and the godown keeper and the delivery note if any. He should see that the names of the creditors in the sales book has been entered in the purchases book.

While examining the invoices the auditor should pay attention to the following points.

1) Whether the invoice is in the name of his client.
2) Whether the person who ordered the goods is authorised to do so.
3) The date of the invoice should relate to the period under audit.
4) The auditor should also see that the goods mentioned in the invoice are not capital goods
5) He should, as a test check compare some invoices with the goods inward book in order to see that the goods have been actually received.
6) The auditor should check the casts and cross casts of the purchases book.
7) He should see that the trade discount has been deducted from the invoice before making the entry in the purchases book.
8) To inflate the profits, sometimes it is the practice of the management to include the goods purchased in the closing stock, while no entry was made in the books. In this connection he should pay particular attention to the purchases made at the close of the year to see that they are included both in the purchases book as well as in the stock book, otherwise he will be held liable to pay damages as was decided in the case of Smill Vs Offers and others.
9) The auditor should stamp the invoice or cancel it after he has compared it with the entries in the purchases book to prevent its being purchased again.
10) Sometimes the officials of the company purchase goods through the company in order to take advantages of the trade discount. In such a case he should see that the adjustment regarding this has been made in the books of accounts.
11) If any duplicate invoices are produced for verification, then the auditor should satisfy himself that the reasons for the presentation of duplicate invoices in the place of original one.
12) In order to be sure that all the invoices are included, the auditor should ask his client to write to all the creditors to send their statements of accounts direct to the auditor for comparing with ledger accounts.
13) If the invoice runs into several pages the auditor should see that the grand total is correct.

Purchases Returns :

When the goods are returned to the seller, being not according to the sample, a credit note should be obtained. The auditor should compare the credit note with the purchases returns book and the gate keepers outward book or the stores record. He should pay particular attention to heavy returns.

5.10. Sales Book – Sales Returns Book

First the auditor should see that the internal check system is efficient. If it is not so he should disown his responsibility. If it is efficient he should apply a few test checks.

He should compare the date of the copy of the invoice with the date in the sales book.

The entries in the sales book should be compared with the invoices, order Received book, Delivery note duly signed by the purchaser, receipts issued by the transport company or the Railways.

He should further see that the sale of an asset is treated as ordinary sale, otherwise profit will be inflated.

With the permission of the client the auditor should send statements of account to the customer's to confirm the accuracy of the balance in their accounts.

He should check the sales book for the last days or weeks of the financial period and the returns. Inward book for a few days or weeks after the close of the period in order to see whether fictitious sales or returns has been recorded to inflate profit.

7) He should check the casts of the sales book.

8) The cancelled invoices should be checked with the duplicate copy of the invoice.

9) Sales tax, Insurance charges etc; which are recoverable from the customers should be debited to the customers account.

10) Sales to allied concerns should be carefully examined as there may be fictitious entries with a view to inflate profits.

11) If there is a significant difference of trade discount allowed to two different purchasers he should inquire into the reason of such a distinction.

Sales Returns :

When the goods are returned from customers, they should be entered by the gate keeper in the register known as gate keeper in the register known as gate keepers Returns. Inward book and the stock register. The goods returned should also be recorded in the sales returns book and a credit note should be prepared to be sent to the customers. Such a credit note should be signed by a responsible official. The auditor should pay particular attention for this transaction as there is more scope for committing fraud under this head. If there is time lag between sale and return. The auditor should see whether the returned goods were in good condition. Returns from sister concern should be carefully examined to see their genuineness.

The auditor should vouch these transactions with the gatekeepers Returns Inward Book and with the carbon copies of the credit notes sent to the customers or the debit note received from the customers.

5.11. Summary :

Examining the documentary evidence of the transactions appearing in the books is known as 'vouching'. It is the essense of auditing. A voucher is a documentary evidence of a transaction which may be a carbon copy, a receipt or a contract. Before starting the work of vouching the auditor must himself satisfy with the system of Internal check employed by the concern. After vouching the cash book both sides of receipts and payments, he should vouch the trading transactions.

5.12. Model questions

1) How do you vouch the receipts side of cash book ?

2) What is the voucher ? What do you understand by the term 'vouching' in Audit.

3) How would you vouch the following ?

   1) Income from investments.

   2) Petty cash payments.

   3) Travelling expenses.

4) What do you mean by 'vouching' ? What are the points an auditor should look into when examining vouchers ?

5) How can you vouch wages ?

6) How will you vouch a Sales Book and a Sales Returns Book ?

7) Explain the points you would keep in view while auditing the sales.

8) Discuss the steps that should be taken by an auditor in vouching credit purchases and purchases returns.

5.13. Reference books

Principles of Auditing	**:**	**R.G. Saxene**
Principles & Practices of Auditing	**:**	**B.N. Tandon**
Principles & Practices of Auditing	**:**	**Jegadish Prakash**
Contemporary Auditing	**:**	**Kamal Gupta**

- Dr. Ch. Suravinda

Lesson - 6

VERIFICATION AND VALUATION OF ASSETS

6.0 OBJECTIVES

After studying this lesson you should be able to understand the following concepts.

* How to verify the assets
* How to value the assets

Structure

6.1 INTRODUCTION

One of the important duties of an auditor in connection with audit of the accounts of a concern is to verify the assets and liabilities appearing in the Balance Sheet of a Business concerns. Verification means 'proving the truth'or confirmation. He has not only to examine the arithmetical accuracy and bonafide of the transactions in the books of account by vouching only. But he has also to examine that the assets as recorded in the Balance Sheet actually exist. He also see whether a particular asset as recorded in the Balance Sheet on the day of the closing of the books of account exists or not. The accuracy and profits depand upon the correct valuation of assets. According to accepted principles assets are generally classified into fixed assets, and floating assets. The procedure of verification changes according to the nature of assets.

6.2 VERIFICATION

The examination of the books of account with a view to ascertain their arithmetical accuracy is not enough. The auditor must verify that the various items appearing in Balance Sheet are in the possession of the concern under audit.

Verification is a process by which the auditor satisfies himself, by actual inspection or otherwise, as to the existence, ownership, valuation and accuracy of the various items appearing in the balance sheet.

Spicer and Pegler have defined verification in the following words: “The verification of assets implies on enquiry into the value, ownership and title; existence and possession, the presence of any charge on the assets”.

In the words of Lan caster, “the verification of assets is a process by which the auditor substantiates the accuracy of the right hand side of the balance sheet and must be considered as having three distinct objects -

a) The verification of the existing assets

b) The valuation of assets

c) The authority their acquisition.

Advantages of Verification of Assets

Careful verification of assets will fetch the following advantages to the client of the auditor.

1. Avoidance of manipulation and embezzlement.

2. Guard against improper use of assets.

3. Proper recording and valuation of assets.

4. A true and fair position of the business shown by the balance sheet.

The verification of assets involves the following stages.

1. Comparing the ledger accounts with the balance sheet.

2. Verifying the existence of the assets on the date of the balance sheet.

3. Satisfying that they are free from any charge or mortgage.

4. Verifying their proper value.

5. Assets were acquired for the business and are clearly state in the balance sheet.

6. There are in the possession of the client or persons authorised by them.

6.3 VALUATION - DEFINITION

The valuation and its basis will differ according to the type of assets and the purpose for which they are held. ‘However, he can always apply certain tests to find out the value of the assets.

According to Lancaster "An Auditor is not a valuer and cannot be expected to act as such. All that he can do is to verify the original cost price and to ascertain as far as possible that the current values are fair and reasonable and are in accordance with the accepted commercial principles".

6.4 ROLE OF THE AUDITOR IN THE VALUATION OF ASSETS

Auditor plays an important role in the verification and valuation of assets. The acuracy of the balance sheet and the estimated profits of a concern depend upon the correct valuation of the assets. Following points indicate the role played by the Auditor while valuation of assets.

1. The object of the valuation of assets is to show that the balance sheet represents a true and fair view of the state of affairs of the concern and that there is no manipulation of accounts to inflate the profits.

2. The auditor has simply to apply certain tests regarding the valuation of the assets.

3. He is to enlite to rely upon the certificates of competent persons such as valuers, surveyors, etc.

4. He should refer to the invoices to findout the price at which such assets were acquired.

5. Auditor should consider whether the assets are valued at replacement or reliable value.

6. The auditor has simply to apply the accepted principles of valuation.

7. If he is not satisfied with the mode of valuation, he must mention that fact in his report.

8. He should prove that the assets are not to be valued for the purpose of balance sheet at their break up values as if the business was closed.

9. The auditor while valuation of assets should take into consideration their original cost, the probable working life of the assets, the wear and tear of the assets, break-up value of the assets, and the chances of the assets becoming obsolete, to see that the basis of valuation and the calculations are correct and that all contingencies are provided for.

10. In the cae of assets like cash, bills receivable and investments an inspection should be made by the auditor personally on the date of the balance sheet.

11. If there are several cash balances or a large number of investments, the auditor should verify all of them at the same time to avoid the possibilities of substitution.

12. In case it is not possible to check all of them in one sitting, he must keep all the securities and cash balances under his control and possession until he has completed his verification.

6.5 ADVANTAGES OF VALUATION OF ASSETS

Valuation of assets is an important part of verification.

1. The true and fair view of profit and loss account and balance sheet depend on the correct valuation of assets.

2. Over valuation or under valuation of assets may not possible with strick valualtion of assets.

3. even though the auditor is not an expert, he must be cautious and painstaking in verifying the values of the assets at which are shown in the books.

6.6 VERIFICATION AND VALUATION OF ASSETS

For verification and valuation of different assets, we can classify assets into the following groups -

1. Fixed assets.

2. Intangibel assets.

3. Floating assets

4. Fictitious assets.

6.6.1 Fixed Assets

Fixed assets are puchased for permanent use in the busines. The hole business is carried on with the help of these assets. Fixed assets are usually valued at the going concern value, i.e., cost price less depreciation.

While verifying the fixed assets an auditor must satisfy himself with regard to the following points.

1. See that the record of the fixed assets has been maintained in a proper manner and the complete inventory of all the fixed assets is available.

2. See that the fixed assets bear proper marks of identification.

3. See that the management planned detailed procedure regarding frequency and coverage for the physical verification of fixed assets by competent perosns, preferably having some technical background.

4. See whether all fixed assets are verified periodically and regularly and the physical existence is reconciled with records. In case of discrepancies, if any, what actions have been taken?

5. See that there is a written procedure for the verification of fixed assets.

6. See that verification is usually carried out by those who are familiar with the assets.

7. Check the procedure for the verification of fixed assets in the possession of their parties.

8. Check whether the reports of internal verification of fixed assets indicate any damanged or obsolete assets.

9. Check whether the fixed assets are properly insured. has there been any claim during the year? If so, how has it been dealt with in the accounts?

10. See that the fixed assets have been properly valued after depreciation and disclosed in the Balance Sheet according to the requirement of Scheduled VI of the Companies Act.

11. See that a proper system of authorisation and approval regarding the acquisition and disposal or replacement of fixed assets is followed in the organisation.

12. See that the documentary evidence has been checked to ensure actual receipts of the purchased assets and the supplier's invoices have been traced into fixed assets records.

(1) Plant & Machinery

In case the machines are purchased in the current accounting period the invoices and the agreement with the vendors should be verified. If the machinery was existing in the previous accounting period, the auditor should examine the schedules of plant and machinery prepared and certified by the engineer incharge to ascertain the capital outlay. In case where additions have been made to the machine, the auditor should vouch these additions and see that they are shown distinctly. Expenses incurred on custom duty, freight and erection of machine etc., must be debited to Machinery Account. Any expenditure on repairs and renewals should be charged ot Revenue Account.

If the Plant Register is maintained, he should inspect this Register to ascertain that depreciation on machinery is adequate or not and the working life of the machine has been correctly estimated.

He should prepare a list of each machine from the Plant Register and should get the list certified by the works manager. Since he is not a technical man he has to depend upon the advice of the works manager regarding their valuation and the depreciation charged on each machine.

He should see that Plant and Machinery Account is shown in the Balance Sheet at cost less depreciation after making proper adjustment regarding purchases of machinery and sale of some parts effected during the year under audit.

In case machines are in a foreign branch the auditor should obtain certificates from the professional verifiers in the foreign country.

If any plant and machinery has been scrapped, destroyed or sold, the auditor should ascertain that the profit or loss arising. Thereon has been correctly determined. He should obtain a certificate from a senior officer that this has been done.

(2) Furniture

The auditor should examine the invoices of the dealers in case the assets have been acquired during the current accounting period. Any expense incurred in the purchase of the asset should be debited to the Furniture Account. The addition made during the period should be examined in the usual manner. Repairs to furniture during the current year should be debited to revenue account. For the assets existing during the previous accounting period the values should be verified from the schedule of assets of the previous accounting period. The auditor should enquire into the methods of charging depreciation. He should see that whenever a piece of furniture is purchased it must be properly recorded in the stock register and numbered to avoid any kind of pilferge.

(3) Property

The auditor should verify this item in detail and for this purpose he should distinguish between the freehold property and the leasehold property.

(a) Freehold Property : Where freehold property has been purchased, he should examine the title deeds e.g. the purchase deed, the certificate of registration, the broker's note and the auctioneer's account etc. in order to verify the correct position. As regards the purchase price of the freehold property, he should refer to the statement of purchase received from the client's solicitors. He should see that the property is in the name of the client. He should also see that the conveyance deed has been registered in accordance with the Indian Registration Act.

In case where the property has been mortgaged. The auditor should obtain a certificate from the mortgagee regarding the possession of title deed and the outstanding amount of loan. In case the property is rented out, he should exmaine the receipt of the rent particualarly the receipt of the last rent collected.

If the property has been acquired in the current year the cost may be verified with the help of the bank pass book. He should also vouch all the payments made in this connection.

He should also see that a separate account for building and land on which it is constructed is maintained. It is necessary because depreciation is provided for building and not for the land.

(b) Leasehold Property : In the case of a leasehold property the auditor should take the following steps to verify this asset.

He should examine the lease contract to find out value and duration. 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). He should see that the terms and conditions of lease are properly complied with. He should also examine the last receipt of the payment of lease rent. In case the property is sub-let he should examine the tenant's agreement.

He should see that depreciation is duly provided for the value of the lease and for this purpose the original value of the lease mut be examined.

Property which is in the process of construction but has been shown in the balance sheet, the auditor should check the following points:

1. He should examine the certificate of the architect for the completed works. He should see that only the completed works are included under this heading in the balance sheet.

2. He should see that the allocation between revenue and capital expenditur is made correctly. This is very important where the construction is being undertaken by the staff of the client.

3. He should obtain a certificate from a responsible officer about the capital expenditure incurred.

(4) Loose Tools, Patterns, Dies etc.

Such assets have short useful life and the value per unit is also low. Hence no separate accunt is maintained for each unit.

1. The auditor should examines the list of the loose tools.

2. The auditor should see that the list has been certified by a responsible officer.

3. This type of assets comprises items like small tools, dies jigs, moulds etc. Some of them are liable to be lost and same of them consumed very rapidly. Hence the conventional method of depreciation is not applied to them. "Montgomery" suggests "charging the cost of replacement of such items to maintain in lieu of depreciating them is usually a satisfactory alternative'.

4. Where the company makes its own tools, the auditor should see that they are not valued in excess of the cost.

Investments

1. Schedule : If there are a large number of investments, as in the case of banks and insurance companies, the auditor should ask for a schedule of investments held by his client. The schedule should disclose full particulars of the investments, e.g. name of the investment, the cost price, the market price, book value, date on which the investment was acquired, rate of interest payable and the dates of the payments of interest, tax deducted and so on and compare these with the records in the books of his client.

2. Transfer Deed : In the case of purchase of stocks and shares for which no certificate has been issued till the date of verification, the transfer deed will be a good evidence for the purpose. when new shares have been applied for, the receipt for the application money or the allotment letter should be examined.

3. Comparison: (a) The auditor should examine all the investments simultaneously and compare them with the schedule. If the number of the investments is large and they cannot be inspected at one sitting, the investments which have been checked must be locked and sealed in a box so that they may not be produced again at the time of the next inspection.

(b) Where these investments are held by any trustee on behalf of the company, the trust deed executed by such a nominee should be examined. In the absence of a trust deed, he should get a certificate from the trustee that the latter holds those securities in trust and that they are free from any charge, and that they are in favour of the nominee or any other person.

(c) If the securities have been entrusted to the bankers for safe custody, the auditor should get a certificate from the bank regarding the number of securities held by it for safe custody and to check that they are free any charge.

Land

The verification procedure for land can be as under:

1. Land is not consumed in the course of business, hence it is not subject to depreciation. Thus the auditor should see that land is shown in the Balance Sheet at original cost basis. The method of valuation is the same whether it is freehold land or leasehold land.

The auditor can check the cost with reference to the original purchase contract. He should also see the minutes of the Board of Directors authorising the purchase.

2. The auditor should see that land is not subject to any charge or mortgage, etc.

3. The auditor is not competent to check the title deeds, the purchaser's note etc. Therefore, he should get a certificate regarding their validity from the solicitor.

4. Cost of land will be increased if the following expenses are incurred - broker's commission, title examination fees, improvement expenses, etc.

Where the land has been given on rent by the client, the auditor should examine the agreement and other relevant date. He should also check that the ground rent receivable has been properly accounted for.

Motor Lorries and Vans

1. Where the number of vehicles owned is large, it is desirable that a register, like the Plant Register, be maintained for them. Such a register may be called the Vehicles Register. The auditor should obtain a schedule of all motor vehicles owned by the company together with the registration books and insurance policies.

2. The Auditor should also go through the log book and carry out physical inspection of the vehicles. The auditor should examine the Registration Book for each vehicle. While comparing it with the ledger account of the Vehicle Register, road tax and insurance premium receipts should be examined.

3. On examination, if it is found that some vehicles are not registered in the client's name he must ascertain the reasons for this and obtain a written confirmation from the person named in the registration book that the vehicle is the property of the client and that no charge is claimed thereupon.

4. Where the original cost of these assets is appreciably high there will be heavy wear and tear. In such cases, the auditor should ensure that the rate of annual depreciation applied is adequate. All additions during the year should be carefully scrutinised to ascertin that only actual additions by way of new acquisitions are capitalised, and that repairs and replacements have been charged off to revenue.

6.6.2 Intangible Assets (Wasting Assets)

Any asset having no concrete form and not capable of being perceived especially by the sense of touch is an intangible asset. But it is no less useful for the business and is also realisable in cash. Goodwill, patents, copyrights trade marks, etc. are examples of intangible assets.

Goodwill is a fixed asset of a peculiar nature. It is an intangible asset and its value depends upon the earning capacity of the business. Goodwill is normally shown as an asset in the Balance Sheet when:

1. The amount paid for the purchase of a business has been in excess of its net assets,
2. The company has made revaluation of its assets and raised a goodwill account in its books,
3. Goodwill once written off is later brought back in the books to write off the debit balance of the Profit and Loss Account or capital losses that the company might have suffered,
4. Heavy expenditure is incurred in introducing a new product in the market or in rendering service to the customers,
5. The Company has established a special reputation in the market because of its increasing sales and profits.

    1. Goodwill
    2. Patents
    3. Copyright
    4. Trade Marks
    5. Preliminary Expenses

Verification Procedure :

1. If goodwill is shown in the books of account, the auditor should verify it by referring to the contract with the vendors to find its value.

2. If goodwill has been purchased as an asset, the vendors' agreement and the resolution of the Board of Directors would provide the auditor with sufficient evidence. he should see that the sum paid for goodwill does not exceed the difference between the total purchase consideration and the value of the net tangible assets acquired.

3. The auditor should see that regular revenue expenditure is not capitalised. Deferred goodwill must be clearly shown in the Balance sheet to differentiate it from the 'purchased goodwill'. The auditor should see that such a goodwill is written off within a reasonable time.

4. The auditor should see that the goodwill is shown separately in the Balance Sheet stating its valuation method clearly.

5. Where goodwill has become fictitious becuase of continued heavy losses or sale of major part of the undertaking, the auditor should advise his client to write off the amount of goodwill so that the financial accounts disclose true and fair poistion of the business.

Patents

The audit procedure regarding patents is as follows:

1. The auditor should insist upon his client to supply him a list giving the description of each patent, their registered number, date, and number of years to run.

2. He should check the certificate of grant of patent or the assignment of the interest in it and should also verify the cost and any subsequent expenditure of futher protection of it.

3. He should see that renewal fees has been charged to revenue.

4. The cost of patent should be written off in the course of its life. The auditor should see that this is being done.

5. Sometimes a patent might become valueless due to obsolescence or failure to create a demand of the patented article. In such a case, the auditor should see that its value is written off even before expiry of the period covered by the patent.

Copyrights

The verification procedure of an item under this heading in a Balance Sheet will be on lines similar to those just described in the case of patents. The best method of dealing with copyrights is to revalue these at the end of each financial year. Where any pub lication ceases to command sales, the copyright in respect thereof losses its value, and the cost of publication of such work should, therefore, be written off as a loss.

Trade Marks

The auditor should verify the Trade Marks by examining the assignment deed duly endorsed by the office of the Registrar of trade-marks. It should be seen that the trade marks are registered in the name of the client and are his property. he should also vouch the payment in case the trade-marks has been purchased. The renewal payment reciepts must also vouched. he should see that any expenditure incurred in the acquisition of the trade-mark has been treated a s a cpaital expenditure. All research expenses in this connection should also be capitalised. The effect of obsolescence on the trade-mark should also be noted. Trade-marks should be disclosed in the Balance Sheet at the original cost less depreciation.

Preliminary Expenses

Although these items appear on the assets side of the Balance Sheet, they are in fact revenue expenditures which are for the time being "held up". The Companies Act allows these to be shown on the assets side of the Balance Sheet until written off, but as they do not represent any tangible values, it is better that they are written off earlier.

The auditor should ensure that commission paid on shares and the preliminary expenses paid do not exceed the limits laid down in the Comapanies Act. The writing off procedure given in the Act should also be followed in this connection.

6.6.3 Floating or Current Assets

Floating assets are those assets in which the form deals in normal operation of the business. Such assets are subject to constant changes and rotation. They are convertible into cash within a relatively short period of time. Floating assets include the circulating or liquid assets or current assets, the examples being stock in trade, cash, bills receivable, debtors, short-term securities and pre-payments.

Book Debts

One of the very important duty of the auditor in connection with verification of debtors is to see that the debts as shown in the Balance Sheet are recoverable. If they are doubtful, adequate provision has to be made for them. When they are bad, i.e. they are irrecoverable, they are not shown on the assets side. Where the auditor does not pay any attention to these points, the Balance Sheet which he certifies to show a "true and fair view" may be wrong and he might be held liable for damages.

Thus, the objective of verification of debtors is to establish : (i) its accuracy (ii) its validity as claims agianst the recorded debtors, (iii) its collectibility and determination of its realisable value, and (iv) its fair disclosure in the financial statements in accordance with legal provisions. Verification of debtors balances should be carried out by employing the following procedures:

1. Year-end scrutiny and checking of balances

2. Test checking of subsequent recoveries

3. Direct Confirmation Procedure

Direct confirmation of balance from the debtors is the best evidence in suppport of outstanding balances. But such confirmations are not always avaialbel and it should be remembered that such confirmations will not being to light suppressed debtors balances, resulting from the suppression of sales.

The institute of Chatered Accountants of India through its Statement on Auditing Practices recommends that the direct confirmation of balances should be based on the following:

1. Confirmatory letters should be obtained from the debtors directly by the auditor. Arrangements should be made with the client for sending out these letters to the debtors.

2. The auditor should see that the debtors' ledger trail balance is extended by clients and agreed with the control account, if any. Where the number of debtors is small, all of them may be circulated, but if they are numerous this could be done on a test basis. The auditor should ensure that the method of selection of the customers to be circularised is not revealed to the client until the debtors ledger trail balance is handed over to the auditor. A list of debtors selected for confirmation should be prepared in duplicate and a copy handed over to the clients for preparing requests for confirmation which should be properly and fully addressed.

3. The auditor should see that client's staff is not given an opportunity to prevent despatch of the confirmatory letters to any particular debtors.

Loans and Advance

The verification procedure for loans and advances is almost the same as for debtors. The additional points for verification of this item are as follows.

1. The auditor should pay special attention to the sanctioning of loans by the Board of Directors.

2. If there are any debtors for loans granted by the company, the auditor should see that the amount of such loans is not included in the list of sundry debtors but is shown separately.

3. Where such loans are secured, he should inspect the securities and obtain letters from the debtors acknowledging the amounts owned by them on the date of Balance sheet. Where the loans are unsecured, the auditor should enquire if the amunt is recoverable in full.

4. The auditor should examine all the documents relating to the loan and satisfy himself that the borrower is competent to receive the loan.

5. Where loans are owned by the directors or other officers of the company, it should be seen that a clear statement to that effect is made on the face of the Balance Sheet.

6. The auditor should further satisfy himself that loans, advances or deposits made by the company are within the powers of the company as laid down in its Memorandum and Articles of Association.

7. As far as loans to companies are concerned, the auditor should specifically note that the provisions of the Sec.370 are complied with.

Figure Showing Classification of Fixed Assets

Loans of Employees : Sometimes loans are made by firms and companies to their employees to assit them to purchase houses or meet other occasional expenditure. In such caes the loan agreements or other documents signed by the employees acknowledging such loans must be inspected and the terms in respect of interest, if any, and repayment noted.

a. Loans given to bodies corporate, not under the same management should not exceed 10% of the capital and free reserve of the lending company.

b. Where loans are in excess of the above limit the prior approval by special resolution of members of the company has been obtained. In case the loans made to the bodies corporate exceed (i) 20% of the capital and free reserves of the lending company (where the borrowing and lending companies are under the same management) and (ii) 30% of the capital and free reserves (where the companies are not under the same management), in addition to the special resolution, approval of the central government must have been obtained.

Verification of Bills Receivable : The audit procedure for bills receivable are as follows :

1. The auditor should compare the schedule of bills in hand at the date of the Balance sheet with the Bills Receivable Book.

2. Bills on hand should be verified by actual inspection of the bills, care should be taken to see that no overdue bills are included.

3. If any bills have been met subsequent to the period but prior to the date of audit, the same should be traced through the Cash Book.

4. If the bills are lodged with the bankers for collection, a certificate should be obtained from the bank stating the bills on hand at the date of the Balance Sheet.

5. In regard to bills that have been discounted or endorsed away and remain unmatured on the date of audit, the auditor should ensure that the contingent liability in respect thereof has been shown at the foot of the Balance Sheet and a proper reserve has been made in regard to overdue bills.

Verification of Investments in Subsidiary Companies : The auditor should ensure that dividends received after acquisition of controlling interests, if paid out of pre-acquisition profits, are credited against the cost of the shares, thereby reducing their value, as the holding company has since received part of the value which it originally purchased.

Advance Payments : The three major objectives for verification of this item are (a) to establishe the validity of the expenditure originally debited to an asset account, (b) to determine that definite benefits will be received in future periods from any unexpired cost being carried forward as an asset, and (c) to determine the reasonableness of amortisation programme being applied to such an asset.

6.6.4 Fictitious Assets

An asset which, like an intangible asset, does not have a concrete form but which, unlike it, is not realisable in cash, is a fictitious asset. In fact, fictitious asset represents capitalisation of expenditure which is essentially of a capital natue and the benefit thereof is expected to be available in future years. Preliminary expenses, special advertising expenses, expenses on issue of debentures and discount thereon, and development expenses, are examples of fictitious assets.

Although these items appear on the assets side of the Balance Sheet, they are in fact revenue expenditures which are for the time being “held up”. The Companies Act allows these to be shown on the assets side of the Balance Sheet until written off, but as they do not represent any tangible values, it is better that they are written off earlier.

The auditor should ensure that commission paid on shares and the preliminary expenses paid do not exceed the limits laid down in the Comapanies Act. The writing off procedure given in the Act should also be followed in this connection.

6.6.5 Verification of Some typical assets

Assets Acquired on Hire Purchase

Legally in such assets ownership does not vest in the company. But such assets should be recorded at their cash value. Where it is not redily available, it should be calculated by assuming an appropriate rate of interest. They should be shown on the Balance Sheet with an appropriate narration to indicate that the company does not have full ownership.

Jointly Owned Assets

In case a company owns assets jointly with others(Other than as a partner in a firm), the auditor should see the extent of the company's share in such assets and its proportion of the original cost, accumulated depreciation and written down value have been stated in the Balance Sheet. Alternatively, he can check that the pro rata cost of such jointly owned assets has been grouped together with similar fully owned assets. He should also ensure that details of such jointly onwned assets are indicated separately in the fixed assets register.

Purchases in Lot

When several assets are purchased for a consolidated price, the auditor should see that consideration has been apportioned to the various assets in the ratio of their respective market values on the date of purchase as assessed by expert valuers in addition to the other considerations discussed above.

As-sets

Fixed Assets
- Plant & Machinery
- Investment Land
- Land & Building (Property)
- Furniture & Fitting
- Motor Lorries & Vans

Intangible Assets
- Good Will
- Patents
- Copyrights
- Trade Marks

Floating Assets
- Cash
- Stock
- Book Debts
- Loand & Advances
- **Loand to employees**
- Bills Receivables
- Investment
- Advance Payments

Fictitious Assets
- Preminary Expenses
- Special Advert., Exp.,
- Expenses on issue of Debentures
- Development Expenses

Typical Assets
- Assets acquired on Hire Purchase
- Jointly Owned Assets
- Purchase in lot

6.7 SUMMARY

Thus auditor verify and value each and every asset. He has not only verify the accuracy of accounts and bonafide of the accounts and accounts see that the assets recorded are in existence. Assets are divided into fixed assets, floating assets, intangible or wasting assets, fictitious assets, typical assets. Fixed assets should be valued at cost price less depreciation. Floating assets are valued at the date of the balance sheet at original or historical cost price or the market price whichever is the lower. Intangible assets should be shown at cost price.

6.8 GLOSSARY

Replacement Value : It is the amount which would be required to purchase another asset of the same type to replace the existing one.

Realisable Value : It is the amount which the existing asset would fetch it is sold in the open market.

6.9 SELF ASSESSMENT QUESTIONS

Five Marks Questions

1. Define the term Verification.
2. What is meant by Valuation.
3. What is the role of Auditor in Verification and Valuation of Assets.
4. Advantages of Valuation of Assets.
5. How to value and verify Plant and Machinery.

Ten Marks Questions

1. Explain the terms valuation and verification.
2. How to verify and value cash.
3. What is the procedure to verify typical assets.
4. How to verify Fictitious assets.
5. How to verify Property assets.

Twenty Marks Questions

1. Briefly explain Verification and Valuation of different types of Assets.
2. Explain Valuation and Verification of Fixed Assets.
3. Explain Valuation and Verification of Floating Assets.
4. Explain Valuation and Verification of Intangible Assets.

6.10 BOOKS RECOMMENDED

1. Practical Auditing	Tandon
2. Auditing - Principles, Practices and Problems	Jagadish Prakash
3. Auditing Theory and Practice	Paradeep Kumar
4. Principles of Auditing	R.G.Saxeena

- Dr.K.Kanaka Durga

Lesson - 7

Verification and Valuation of Liabilities

7.0 OBJECTIVES

After studying this lesson you should be able to understand -

→ Verification of Libailities

→ Valuation of Liabilities

Structure

7.1 INTRODUCTION

Verification means proving the truth or confirmation. One of the important duties of an auditor in connection with the audit of the accounts of a concern is to verify the assets and liabilities appearing in the balance sheet. He has not only to examine the arithmetical accurancy but he has also to see that the assets as recorded in the balance sheet actually exist. The fact that there is an entry regarding the liability and which entry has been found to be correctly recorded, is not a proof that the liability is in the possesson of the concern at the date of the Balance Sheet.

7.2 VERIFICATION OF LIABILITIES

The Auditor has to verify all the items appearing in the liabilities side of Balance Sheet. If the liabilities are overstated or understated in the Balance Sheet then it will not represent a true and fair veiw of the state of affairs of the company. Similarly the Profit and Loss account will be incorrect and they have not been entered in the books of accounts, it will show more profit and the balance sheet will not show such liability (Westminister Road Construction and Engineering Company).

The auditor, besides verifying the liabilities as shown in the Balance Sheet should also get a certificate from the management that all the liabilities for business purchases as well as for expenses or on any other account have been included in the books of account and that the contingent liabilities have been shown by way of footnotes to the Balance Sheet or have been provided for.

As regards the liabilities, the auditor has to satisfy himself with respect to the following points:

1. that the credit balances appearing in the books are really liabilities;

2. that liabilities not recorded whether by accident or design are brought into books;

3. that they are properly valued;

4. that they are properly classified and disclosed.

5. The Liabilities shown in the balance sheet are actually payable.

6. The recorded liabilities are payable for the legitimate operations of the business.

7. In case of liabilities created by some charge, the nature and extent of such charge has been disclosed.

8. The nature and extent of contingent liabilities has been disclosed in the Balance Sheet.

7.3 VERIFICATION AND VALUATION OF LIABILITIES

The items appearing on the liabilities side of the Balance Sheet and requiring verfiication can be grouped under the following four headings.

- Capital or Owners equity
- Reserves - Capital and Revenue
- Loan Capital
- Liability and Provisions

The verification of liabilities is much easier than their valuation. Different items on the liability side of the balance are to be verified and valued.

CAPITAL

Although Capital is not the liability of a Company, still it should be verified to enable an auditor to give a certificate in regard to the correctness of the balance sheet. Capital is verified in the following way.

a) **In the case of a partnership firm**: While auditing the partners capital, the auditor should first of all examine the partnership agreement. He must find out the original cpaital contributed by the partners, the rate of interest payable on cpaital, the amount of drawings allowed to be withdrawn, the rate payable on capital, salary payable to the partners and whether it will be taken away by the partners or not and so on. The auditor will see that capital accounts have been correctly maintained. He should calculate the interest on drawings and capital.

b) **In the case of a Company**: Viewing from the point of view of the going concern principle, capital is not the liability of a concern. But the auditor must verify its correctness so that he can report on the corretness of the Balance Sheet.

With regard to audit of a company's capital, the duties of the auditor can be put into two categories: (i) At the time of first audit, and (ii) at the time of subseqent audit.

Duties of the Auditor on First Audit : The duties at the time of first audit in brief are the following:

1. He should read the different clauses of Memorandum and Articles of Association of a company so as to note the authorised capital of the company.

2. The auditor should go through the Cash Book, Pass Book, Minute Book of the Board of Directors to know: (i) the number and the different classes of shares issued, (ii) the amount received on each share, and (iii) any balance due from the shareholders in respect of calls.

3. Where some of the shares have been issued for consideration other than cash to vendors, he should examine the vairous clauses of the contract between vendor and the company.

Duties of the Auditor on Subsequent Audit: Regarding the subsequent audit the duties of the auditor are to see that the share capital is same as at the end of the last year. Where he finds that the capital stands altered by isue of fresh shares etc., he should ensure that the relevant provisions of the Companies Act have been complied with.

DEBENTURES

A debenture is a written acknowledgement under the seal of the company for a debt due by the company undertaking to pay the debt and interest on debt. Debentures can be of various types.

Procedure for auditing debentures is briefed as under :

1. The auditor must very carefully ascertain the company's borrowing powers. Whether a company has power to borrow or not depends upon its objects, and the auditor must refer to the Memorandum and Articles for this purpose. A power to borrow, however, need not be expressed. It may be implied, and all trading companies have an implied power to borrow, as the same is regarded as incidental to the carrying on of their business. If there is any limit placed on the borrowing powers of the directors or the managing agents, the auditor should see that such limit is not exceeded.

2. See that all the requirements of the Act in connection with loans on mortgage are rigidly carried out.

3. See that the assets mortgaged or charged are clearly indicated in the Balance Sheet.

4. See that where debentures are issued at a premium, the premium has been used towards reduction or writing off of goodwill or other fixed assets, or has been credited in the Debentures Redemption Fund or in the Capital Reserve Fund.

5. See that where debentures are issued at a discount and are repayable at par, the total amount of liability represented by the face value of the debentures has been shown on the liabilities side. The Discount on Issue of Debentures, being a loss, has to be written off during the term of the debentures, the unwritten balance being shown on the assets side for the mean time.

6. See that where debentures have been issued at par and are repayable at a premium has been provided proportionately out of the profits each year.

7. The auditor should ensure that the terms of issue of the debentures have been complied with.

Loans secured and unsecured

While verifying loans the auditor has the following duties:

1. Check the existence of the loans which he may do with reference to the agreement and correspondence for getting the loans.

2. Check payments on account of interest on laons, where any interest due has not been paid, the auditor should see that it is shown as a liability.

3. Call for confirmation letters from the parties who have advanced the loans. the auditor should seek information not only about the amount of the loan but also about the interest due and the security offered.

4. Check the power of the company to borrow with reference to the Memorandum and Articles of Association and the Companies Act.

5. Ensure that where any properties have been mortgaged by the company, mortgage has been registered with the Registrar of Companies and an entry has been made in the Register of Mortgages.

Liabilities and Provisions

1. The copy of application executed for obtaining the loan should be examined to ascertain the terms and conditions of the loan.

2. If any security has been provided for it, by creating a charge on some asset, the auditor should examine the agreement concerning the creation of the charge and this fact must be disclosed in the Balance Sheet.

3. The borrowing powers of the client must be verified and it must be ensured that loan was raised under proper authority.

4. The amount of interest accrued till the balance sheet date should either be paid or provided for. the auditor must see that this has been done.

6. In case of bank overdraft, he should examine:

    the agreement with the bank,

    the Bank Pass-book, and

    the statement of mortgaged assets.

Trade Creditors

1. The auditor should obtain a certified schedule of creditors from the client and check it with the individual creditor's account in the purchases ledger. Particularly to ensure that all purchases, including those made at the year-end, have been included in the purchases and duly credited to the accounts of the creditors concerned.

Further, the Purchase Ledger should be checked with the books of original entry, invoices, credit notes, etc.

As was held in Westminster Road Construction & Engineering Co. Ltd., the auditor has a duty to determine unrecorded liability in respect of goods received prior to the period under audit which, though included in stock, do not have a corresponding entry under liabilities.

2. The auditor should send confirmation requests to a select number of creditors concerning the balances standing as at the end of the year.

3. If any debt is found unpaid for a long time, enquiry should be made since it is possibel that instead of paying the creditor, the amount might have been misappropriated.

Amount Receivable in Advance

As far as amounts received in advance are concerned, to verify such amount the auditor should obtain a certified schedule thereof from the company or organisation. Not only this, he should further ensure that the entire amount so received has been shown as a liability in the Balance Sheet.

Outstanding Expenses

For verification of outstanding expenses the auditor should obtain a certificate from a responsible official to the effect that all outstanding expenses have been included in the current year's accounts. The examples of such expenses which should be debited to the current year may be apparent, e.g. rent of twelth month, or salaries payable or electricity charges for the last month, etc. Further, he should check entries for some weeks after the Balance Sheet date to ensure that they are not related to the year under audit. He should also ensure that outstanding expenses have subsequently been paid.

Bills Payable

The various steps involved for verification of bills payable are given below :

1. He should obtain a schedule of bills payable and compare the same with the Bills Payabla Book and Bills Payable Account.

2. The Bills that have already been paid should be cerified with the Cash Book.

3. To ensure that no fictitious bills have been included, he should examine the Cash-Book of the succeeding year to see that the payment has been made in respect thereof. In case any soul play is suspected, he should seek direct confirmation from the drawers of the bills.

4. He should also note that where any charge has been created on any asset of the concern by accepting the bill, note to this effect has been stated in the Balance Sheet.

Contingent Liabilities

There may be certain liabilities which may or may not arise after the preparation of the Balance Sheet. Such liabilities are called contingent liabilities.

The duties of the auditor with regard to contingent liabilities are the following.

1. To ensure that all such likely libilities have been accounted for and shown in the Balance Sheet. The amount of such liabilities can be estimated by referring to the books of account, correspondence, minute book etc.

2. Consult the solicitor of the client to assess the value and genuineness of such liabilities.

3. To ensure that the provisions of Schedule VI, Part-I of the Compananies Act, 1956 which prescribes the form of company's Balance Sheet are complied with regard to contingent liabilities.

7.4 ADVANTAGES OF VERIFICATION OF LIABILITIES

Careful verification of liabilities will fetch the following advantages.

1. A true and fair position of the business shown by the Balance Sheet.

2. Proper recording and verification of liabilities.

3. Guard against misappropriation of loans.

4. Avoidence of unnecessary loans.

7.5 DIFFERENCE BETWEEN VERIFICATION AND VOUCHING

Verification and Vouching differ in the following way.

VOUCHING	VERFICATION
1. Arithmetical Accurancy : In vouching the auditor only examines the arithmetical accuracy and bonafide of the transactions in the books of account	In verification he has to ensure that the assets as recorded in the balance sheet really exist
2. Checking : In vouching only the entries are checked.	In verification once the auditor is sure of the existence of assets he has to check up whether the assets are free of charge or not.
3. Existence : In vouching the auditor comes to know what should be in existence.	In verification the auditor comes to know the actual existence, freedom from encumbrances and proper valuation of assets.
4. Inquiry : In vouching the auditor check receipts and vouchers.	In verification the auditor should also inquire of the executives about the ownership or leased property.
5. Legal Documents : In vouching auditor may not go through the vouchers.	In verification, the auditor can look at and go through the legal and official documents as also interrogate the responsible officials of the client.

7.6 SUMMARY

Verification of liabilities is as much important that of assets. Liabilities are not the statements of opinion but statements of fact in most of the cases. The contingent liability is, however, exception to this as it is only an estimate, but it is not included with other liabilities. The question of valuation of liabilities does not arise as exact amount of responsibilities can be determined. Capital is the important item on the liabilities side of the Balance Sheet. It should be verified exhaustively, particularly in the first audit.

While a verfication of Debentures he should keep in mind the provisions of section 293(1) (d) of the companies Act 1956 putting limitations on borrowing. In case of redeemable debentures have been issued, the auditor should ascertain the terms of redemption. In case of trade creditors he should obtain statements of account from the various creditors directly and then verify them carefully. While verification of bills payable he should call for letters of confirmation from the drawers of the bills and check the amount of unpaid bills. Thus loans, outstanding expenses contingent liabilities are verfied carefully.

7.7 SELF-ASSESSMENT QEUSTIONS

Five Marks Questions

1. What are advantages of verification of liabilities.

2. How to verify the Capital on Liabilities side of Balance Sheet.

Ten Marks Questions

1. What are the differences between Vouching and Verification.

2. Explain Verification of any four Liabilities.

7.8 GLOSSARY

Contingent Liability

It is used in the accounting sense to designate a possible liability of presently determinable or indeterminable amount which arise from past circumstances.

Outstanding Expenses

The expenses which are due but not paid.

Debenture

A debenture is a written acknowledgement under the seal of the company for a debt due by the company undertaking to pay the debt and interest.

Secured Loans

Loans having a charge or mortgage.

7.9 BOOKS RECOMMENDED

1. Practical Auditing	Tandon
2. Auditing - Principles, Practices and Problems	Jagadish Prakash
3. Auditing Theory and Practice	Paradeep Kumar
4. Principles of Auditing	R.G.Saxeena

- Dr. Kanaka Durga

Lesson - 8

COMPANY AUDITORS - I

8.0 OBJECTIVES

After studying this lesson you should be able to understand the following.

→ Appointment, removal of an auditor

→ Qualifications, disqualifications of an auditor

→ Remuneration of an auditor

Structure

8.1 INTRODUCTION

Appointment, qualifications, disqualifications, removal and remuneration of an under essentially depend upon the form of organisation. If the audit is governed by a statute, the provisions of the statute will play an important role. A sole proprietary concern is not required, under any statute to get its accounts audited. The auditors of such concerns need not necessarily be qualified professional accountants. In case of partnership business, Indian Partnership Act 1932, does not provided for any compulsory audit. But audit in partnership business facilitate the settlement of accounts, raising loans etc., The statute governing companies provides for compulsory audit of the company accounts sections 224 to 233 of Indian Companies Act, 1956 contain the specific provisions regarding audit. These section deal with qualifications, disqualifications, appointment, reappointment removal status of an audition.

8.2 APPOINTMENT OF A COMPANY AUDITOR

Every company even a private company must appoint an auditor to audit its accounts. The provisions regarding appointment of the auditor are contained in section 224 of the Company Act.

First Auditors : Section 224(5) provides for the appointment of first auditors by the Board of Directors within one month of the date of registration of the company. The auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. Sometimes the first auditors of the company are named in the Articles of Association. Such an appointment of auditors cannot be held valid, since the companies act does not recognise it. In the case of first auditors, it is not a necessary condition under the Act that he shall be improved about his appointment. Similarly, the first auditor is not required to inform the Registrar about the refusal or acceptance of the appointment.

Subsequent Auditors : Subsequent Auditor or auditors of a company are appointed every year by the shareholders in annual general meeting by passing an ordinary resolution. Every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting, and shall, within 7 days of the appointment give intimation there of to every auditor so appointed. Appointed Auditor should communicate his acceptance or refusal to the Registrar within the period of 30 days of the receipt from the company of the intimation of his appointment.

Appointment by Central Government : According to section 224(3), where at an annual general meeting no auditors are appointed or re-appointed, the central government, may appoint a person to fill the vacancy. Within 7 days of the power of the central government becoming exercisable, company shall gives notice of the fact to the Regional Director, to whom the central government's power to appoint an auditor in such an event has been delegated under section 637.

Appointment Against a Casual Vacancy :

1. If due to death, insanity, insolvency or other disqualification a casual vacancy of the auditor arises.
2. The vacancy arising out of registration of the auditor or his refusal to accept the appointment is not a casual vacancy. The auditor will hold office till the conclusion of next annual general meeting.
3. The Board has no power to fill such vacancy, even if the shareholders' have authorised it in this behalf. Such a vacancy should be filled by the shareholders' in general body meeting.

Appointment by Special Resolution :

According to the Company Act 1974, under section 224-A in the case of company in which 25% or more of the subscribed sharecapital is held. The appointment of an auditor or auditors shall be made by a special resolution.

If the Company fails to pass a special resolution, it shall be deemed that no auditor or auditors had been appointed by the company at its annual general meeting and the central government will be empowered to make an appointment.

Compulsory re-appointment : According to section 224(2), a retiring auditor, by whatsoever, authority appointed, shall automatically reappointed except in the following circumstances -

1. Where he is not qualified for re-appointment.
2. Wher he is unwilling.
3. Where a resolution has been passed not to reappoint.

4. Re appointment of the retiring auditor shall not be made, if he is already holding auditorship in the specified number of companies.

Appointment of Auditors of government or certain other Companies :

The provisions regarding appoint of government companies are different.

1. Section 619 provides that the auditor of a government company shall be appointed or re-appointed by the Central Government on the advice of the Comptroller and Auditor General of India.
2. He may also conduct a supplementary or test audit of such company's accounts by persons authorised by him in this behalf.
3. The auditor should submit a copy of his audit report to the comptroller and Auditor General of India who has the right to Comment on or supplement, the audit report in such manner as he may think fit and the same should be placed in the annual general meeting at the some time and the some manner as the audit report.

8.3 REMOVAL OF AN AUDITOR

No new auditor can be appointed in place of an existing auditor unless the later has been given a due notice according to the company act. According to law if a due notice has not been given, the resolution regarding the removal of the auditor can not be put before the general meeting.

If any shareholder wishes to nominate any other person in place of the existing auditor, he must give a special notice (14 days) to the company. The company mut send a copy there of to the retiring auditor. Such an auditor will have the right to send a representation to the company which in its turn shall send it to the Shareholders. The company may refuse to end such a representation to the shareholders if the court is satisfied on the application of the company. That this right of representation is being misused by the auditor.

The auditor intended to be removed has also a right to attend the general meeting where his removal is to be discussed. He has also a right to speak at such a meeting. The underlying idea is to prevent the directors to remove an auditor without the knowledge of the shareholders.

An auditor can be removed only by the general meeting with the approval of Central Government. The first auditor who is appointed by the directors to hold office till the conclusion of the first annual general meeting may be removed before the expiry of his term by the general meeting even without the approval of Central Government.

For removal of subsequent auditors, besides passing an ordinary resolution, prior permission of the Central Government, must be obtained. Thus it is difficult to remove an auditor before the expiry of his terms since adequate grounds must exist to prove to the Government that the person or the firm sought to be removed in unsuitable for continuing as the auditor.

8.4 QUALIFICATIONS OF THE COMPANY AUDITOR

Section 226 of the Companies Act, prescribes the qualifications and disqualifications of company auditors. According to section 226(i). "a person shall not be qualified as auditor of a company unless he is a chartered accountant within the meaning of the Chartered Account' Act,1949". It further provides that a firm where of all the partners practicing in India are qualified for appointment as auditors may be appointed by firm's name to be the auditor of the company. In this connection, it may be noted that under the Chartered Accountants Act, , only a chartered accountant having a certificate of practice can be engaged in the public practice of the profession of accountancy. Therefore, only a practicing chartered accountant can be appointed as an auditor of a company.

In addition to practicing chartered accountants, section 226(2) allows a holder of a certificate in an erstwhile Part B State which entitled him to act as an auditor of companies in the jurisdiction of that state, to be appointed as an auditor of companies registered anywhere in India.

Disqualification

Section 226(3) provides the disqualifications. According to it following are disqualified to be appointed as auditor of a company –

a. a body corporate;
b. an officer or employee of the company
c. a person who is a partner or who is in employment of an officer or employee of the company.
d. a person who is indebted to the company for an amount exceeding Rs.1000 or who has given any guarantee or provided any security in connection with the indebtness or any third person.
e. a person who by virtue of the above listed provisions is disqualified for appointment as auditor of any other body corporate which is the company's subsidiary or holding company or a subsidiary of that company's holding company or would be so disqualified if the body corporate were a company.

If after this appointment an auditor becomes subject to any of the disqualifications listed above, he shall be deemed to have vacated his office forthwith.

8.5 LIMITATIONS ON AUDITORSHIP

The Companies Amendement Act, added two new sub-sections 1B and 1C. The objective of these sections is to prevent concentration of audits in few hands. The section was further amended in 1988.

According to see, 224 1B, an individual cannot be auditor of more than 20 companies at a time. Further, out of these 20 companies, not more than 10 should be companies having a paid up share capital of Rs.25 lacs or more. In case of a partnership firm of auditors, the ceiling is 20 companies per partner of the firm if a partner is also a partner in any other firm or firm of auditors, the overall ceiling in relation to such a partner will be 20.

Section 224 1B has been amended by the Companies Amendment Act, 1988 to disallow the appointment of persons who are in full time employment elsewhere. Even in case of partnership, such a partner shall be excluded from counting the number of audits per partner.

8.6 REMUNERATION OF AN AUDITOR

According to Section 224 (8):

1. In the case of an auditor appointed by the Board of Directors or the Central Govt. His remuneration may be fixed by the Board or Central Government, as the case may be.
2. In all other cases, it must be fixed by the company in general body meeting or in such manner as the company in general body meeting may determine.

'Remuneration' includes any sums paid by the company in respect of the auditor's expenses in carrying out his duties. Obviously, the general body meeting can disperse without deciding the amount of the remuneration of the auditor. However, it must provide the manner in which the remuneration can be determined.

If an auditor renders services other than the audit work, he will be entitled to separate remuneration for such work. A separate disclosure of all amounts paid to the auditor in whatever capacity, is required to be made in the Profit and Loss Account.

Where an auditor is re-appointed in the next annual general body meeting, the amount fixed for the previous year continues to be the remuneration of the auditor, unless some specific change is made.

8.7 STATUS

Status of an auditor can be observed under three heads -

1. Shareholders Representative
2. Company Officer
3. Company Employee

Shareholders Representative :

An auditor is appointed by the shareholders except in the case of the first auditor of the company who is appointed by the directors during the currency of the year on account of the death of the auditor or by the Central Government in certain cases. It is the right of the shareholdres to appoint an auditor. He is appointed by them to keep a check on the work of the directors, as far as accounts are concern. he is to send a report to the shareholders even though he might have been appointed by them. In case he is appointed by the directors of the Government his remuneration is fixed by the directors or the Government respectively. the shareholdrs may allow him to continue to act as auditor for the next year or may appoint another auditor with the approval of the Central Government. It is they who pay him, of course, out of the funds of the company. The question is whether he is the agent of shareholders or of the directors, or he is an officers of the company, just like the Secretary, Manager, Accountant, etc. Apparently it appears that he perform the functions of an agent as well as that of an officer of the company. Divergent views have been expressed even by the courts. Let us deal with some of these views.

'Lord Cranworth' in the Course of his judgment in the case of Spackman Vs. Evans, said, "The auditors may be agents of the shareholders, so far as it relates to the audit of the accounts. For the purposes of the audit, the auditors will bind the shareholders".

'Lord Chelmsford' said in the same case. "It seems to me that it would be an unreasonable conclusion from the mode of appointment of these officers that they were thereby constituted agents so as to conclude the shareholders by their knowledge of any unauthorised act of the directors".

Company Officer : Auditor is appointed by the company and his position is described in the section as that of an office of the company. He is not a servant of the Directors on the companies, he is appointed by the company to check the directions and for some purposes and the same extent, it seems to me quite impossible to say that he is not an officer of the Company.

Auditor is to be considered as an officer of the company, he will be held liable under sections 477, 478, 539, 543, 545, 621, 625 and 633 of the Companies Act, 1956. These sections refer to the following matters respectively:

a) Power of the Court in winding up to summon persons suspected of having poperty of the company. S.477.

b) Power of the Court to order public examination of persons guilty of fraud, etc., in the promotion, formation or management of the company, S.476.

c) Penalty for the falsification of books, Section 539.

d) Power of the court to assess damages against delinquent officers, Section 545.

e) Prosecution of delinquent officers and members, Section 545.

f) Cognisance of offences under the Act, Section 621.

g) Payment of compesation in case of frivolus or vexatious officers, Section 625.

h) power of the Court to grant relief to officers in proceedings for negligence, default, breach of duty, misfeasance, etc., provided that in a criminal proceeding, the court shall have no power to grant relief from any civil liability which may attach to an officer in respect of such negligence, default, breach of duty, misfeasance or breach of trust, Section 633.

Company Employee : Auditor may be treated as an employee of the Company, because the law, as the ultimate authority provide certain responsibilities to him. He is appointed by the company and he gets remuneration as an employee.

8.9 SUMMARY

Thus an independent professional auditor, with requisite, qualifications and experience conducts the audit of the books of accounts of the company on behalf of the shareholders by throughly examining them and reporting thereon. His appointment, removal, remuneration, qualifications are strictly according to Companies Act 1956. Except first auditors, auditors are appointed by the Shareholders in general meeting. Remuneration has been fixed by the authorities according to Act. Audit is considered not only representative of the Shareholders but also an officer of the company. In some cases he may be treated as an employee of the Company.

8.10 SELF ASSESSMENT QUESTIONS

Five Marks Questions

1. Qualificaitons of an auditor.

2. Disqualifications of an auditor.

3. Removal of an auditor.

Ten Marks Questions

1. What is the procedure to reappoint an auditor.

2. Explain status of an auditor.

3. How the remuneration of an auditor is fixed?

Twenty Marks Questions

1. What is the procedure to appoint an auditor.

2. Explain qualifications and disqualifications of an auditor.

8.11 BOOKS RECOMMENDED

1. Practical Auditing	Tandon
2. Auditing - Principles, Practices and Problems	Jagadish Prakash
3. Auditing Theory and Practice	Paradeep Kumar
4. Principles of Auditing	R.G.Saxeena

- Dr.K.Kanaka Durga

Lesson 9

Company Auditors - II

9.0 OBJECTIVE

After studying this lesson you should be able to understand the following.

→ What are the Rights of an auditor.

→ What are the duties of an auditor.

→ What are the liabilities of an auditor.

Structure

9.1 INTRODUCTION

Auditors require certain rights and powers to do their duty honestly and justify their authority. Non-company auditor is free to determine his rights and duties with the organisation he agrees to audit. A Company Auditor cannot have this flexibility. The law binds him with certain duties and liabilities along with bestowing certain rights and powers.

9.2 RIGHTS OF AN AUDITOR

The rights are statutory ones and cannot be avoided or curtailed in any way by any resolution or even under a provision in the Articles of Association. following are the rights of an auditor.

1. Right of Access to Books and Vouchers

According to section 227(1) provides that "every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the Company, whether kept at the head office of the Company, or else where". Books of accounts include the financial, statutory and statistical books. Voucher includes all documents, correspondence, agreement, etc., which support any of the transactions or date disclosed in the financial statement, directly or indirectly.

2. Right to call for information and explanation

He has got a right to ask the directors and officers of the company to give any information and explanation of his duty as auditor [sec 227(1)]

3. Right to receive notice and attend general meeting

Auditor has a right to receive a notice of and attend every general meeting. He has a right to speak at such meeting when the accounts are being discussed [sec 231]. An auditor, however, must attend the general meeting in the following circumstances :

i. where he has reasons to believe that the directors may deliberately attempt to conceal a serious state of affiars from the shareholders;

ii. when his audit report contains significant qualifications directly affecting the management, so that his remarks may not be misinterpreted or misunderstood;

iii. when he recieves a notice form the company showing that someone else is going to be proposed for appointment in his place;

iv. where he has been specially asked by the management to be present;

v. where any 'material' mater has come to his knowledge subsequent to his signing the report and would have made his report differently if he had known it before signing the report; and

vi. where the accounts have been altered after the report was appended to the account.

4. Right to make a statement at the general meeting

He has a right to make any statement or explanation he desires at such a meeting in connection with the accounts. If he finds that some wrong statements have been made by the directors relating to the accounts he has the right to correct it.

i. The company auditor thus shall be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor, and

ii. Shall have a right of access at all times to the books and vouchers of the company maintainede at the branch office.

5. Right to Visit Branches

The auditor of a compnay has the right to visit to branches of the company to audit the accounts. If the company is a banking company and has branches outside India the auditor with have no right to visit such branches but will have the right to access to all the returns sent by the branches to the head office [sec 228]

1. The company auditor thus, shall be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor, and

2. Shall have a right of access at all times to th ebooks and vouchers of the company maintained at the branch office.

6. Right to take legal and technical Advice

He has the right to take expert or technical advice but he must give his opinion in the report and not that of the experts. (Re London and General Bank 1895)

7. Right to Remuneration

An auditor has the right to have his remuneration.

8. Right to Sign the audit report

Only the person appointed as auditor of the company may sign the audit report [Sec 229].

9. Right to Correct Wrong Statements

Auditor not only acts as an agent of the shareholders or an officer of the company for limited purposes but also as an observer of law. As an observer he has the right to advice the directors to amend their faulty system of accounts and, if not followed, to report the inadequency of the method of accounts by specifying that the proper books of accounts have not been kept by the company. He can also comment on and correct the wrong statements if any, made by the directors.

10. Right to be indemnified or Granted relief

In terms of Sec.633, an auditor has a right to be indemnified against any liability incurred by him in defending himself agianst any civil or criminal proceeding by the company, provided it is proved to the satisfaction of the Court that he has acted honestly.

9.3 DUTIES OF AN AUDITOR

The duties of an auditor correspond and must necessarily be so with the objectives of audit in hand. The end product of an audit is the auditor's report. Thus, making a report to the members on the accounts of the company becomes the first and foremost duty of an auditor though this duty itself cannot be performed unless he examines and enquires about the various aspects of accounts as well as the mode of keeping these. The law also seeks to ensure that all his legal duties be within his power and justify his profession. Inspite of many provisions in law on this subject there are certain misgivings and unsolved quieries regarding the extent of liability relating to these duties.

In short his duties can be divided into two categories:

1. concerning his work 2. regarding his reporting to members.

9.3.1 Duties Concerning his Work

Section 227(1A) stipulates that it is the duty of the auditor to inquire as follows.

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

b. Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company.

c. Where the company is not an investment company within the meaning of Sec.372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.

d. Whether loans and advances made by the company have been shown as deposits.

e. Whether personal expenses have been charged to revenue accounts.

f. Where it is stated in the books and papers of the company that shares have been allotted for cash, whether cash has actually been received in respect of such allotment, or if no cash has actually been so received, whether the position is stated in the account books and the Balance Sheet is correct, regular and not misleading.

Duties of an Audi-

- **Concerning to Work**
  - Loans and advances
  - Book Entries
  - Securities at less price
  - Deposits
  - Personal Expenses
  - Allotment of Shares
- **Concerning to Report**
  - To make Report
  - To State matter
  - To assist Investiga-tor
  - To Call for informa-tion
  - To Certify Statutory Report
  - To Certify Profit & Loss A/c in Prospectus
  - To Certify Pofit & Loss when Managing agents resign
- **Other Duties**
  - Duty of statement in pro-spectus
  - duty regarding public deposits
  - duty to produce docu-ments and evidence
  - Report on A/cs a Voluntary Winding up
  - Duty to Comply with the Direc-tives

9.3.2 Duties of an Auditor Regarding his reporting to members

a. Duty to make report : An auditor is appointed to keep a check on the directors. He is the agent of the shareholders to examine the accounts maintained and supervised by the directors and to report to them whether the directors have properly maintained the accounts Spacknman vs Earns 1868. But it is not the duty of an auditor to see that his report has been sent or plced in the hands of the shareholders. After having signed his report and the Balance Sheet and having sent it to the secretary of the company his duty is over as was held in Re Allen Craig & Company, London Ltd. in 1934.

b. Matters to be stated in the report: Whether he was obtained all the information and explanation for the prupose of his audit, whether in his opinion the Profit and Loss Account and Balance Sheet referred to in his referred report exhibits a true and fair view of the profit or loss and state of affairs of the company whether proper books of accounts as required by law have been kept by the company whether he has been forwarded the branch accounts audited by other than the company's auditor to prepare his audit report under [sec 228(3)C] whether the Balance Sheet and Profit and Loss Account have been drawn up according to the requirements of the company act under sec 211.

c. Duty to assist Investigators : It is the duty of an auditor to assist the inspectors in every possible way when the affairs of the company are being investigated [sec 240(5)(6)]

d. It is the duty of an auditor to call for information on various points such as (a) whether loans have been properly secured. (b) whether the shares, debentures securities etc., have been sold at what price (c) whether the personal expenses have been charged to revenue account etc.

e. Duty ot certify the statutory report : He has to certify the statutory report as correct according to [sec 165]

f. Duty to certify Profit & Loss A/c. in Prospectus : The prospectus issued by an existing company should contain a statement with regard to profits and losses and assets and liabilities of the company and its subsidiaries. the auditor has to certify such statement in the prospectus.

g. Duty to certify Profit and Loss A/c when Managing Agents resign : Where the Managing agents of a compnay or secretaries and treasurers resign, the Board of Directors shall prepare a statement of affairs from the begining of the year till the date specified. Such a Profit and Loss A/c and Balance Sheet have to be certified b the Companies Auditor [sec 342]

9. 3.3 Other Duties

The Companies Act comtemplates the circumstances which oblige a chartered accountant to report on the statements of accounts, operating results and assets and liabilities of a going company which issues a prospectus. The circumstances are:

(i) when it issues more capital for public subscription;

(ii) if the proceeds of the issue of the shares or debentures are to applied directly or indirectly,

a. in the purchase of a business, or

b. in the purchase of an interest in any business which would make it a holder of more than 50% interest, and

c. if the proceeds of the issue of shares or debentures are to be applied for purchasing shares in a company, making the investing company the majority shareholder.

The report in reference to first case is to be made by the auditor of the company and in remaining cases by any chartered accountant.

1. Duty Regarding Public Deposits by the Company : The auditor of a non-banking company is obliged to enquire under Sec.58(A) and rules made under the directives of the Reserve Bank of india Act, whether the company has furnished the necessary statement regarding public deposits.

2. Duty to produce Documents and Evidence : In terms of Sec.240, a company auditor is under a duty to preserve and produce to an inspector or any other person authorised by him in this behalf with the previous approval of the central government, all books and papers of, or relating, to, the other body corporate which are in their custody or power and otherwise to give to the person all assistance in connection with the investigation which they are reasonably able to give.

3. Report on Accounts on Voluntary Winding up : Under Sec.488(1) where it is proposed to wind up a company voluntarily, the directors of the company have to make a declaration of solvency which includes:

(a) a profit and loss account for the period beginning from the end of the last financial year and ending with a practicable date before the making of the declaration;

(b) a Balance Sheet as on the last mentioned date; and

(c) a statement of the company's assets and liabilities.

The auditor of the company is required to make a report on such balance Sheeet and profit and Loss Account.

4. Duty to Comply with the Directives of the Central Government and that of the Institute of Chartered Accountant of India: This relates to the power of the government to amplify the scope of audit, Sec.227(4)(a). In case the company auditor does not comply with directions given by such bodies, he shall be guilty of professional misconduct.

No limitations can be placed upon the statutory duties of the auditor either by the articles on the other hand the duties of the auditor can be extended by the articles. Therefore the auditor must make himself acquiated with his duties under the Articles and under the Act.

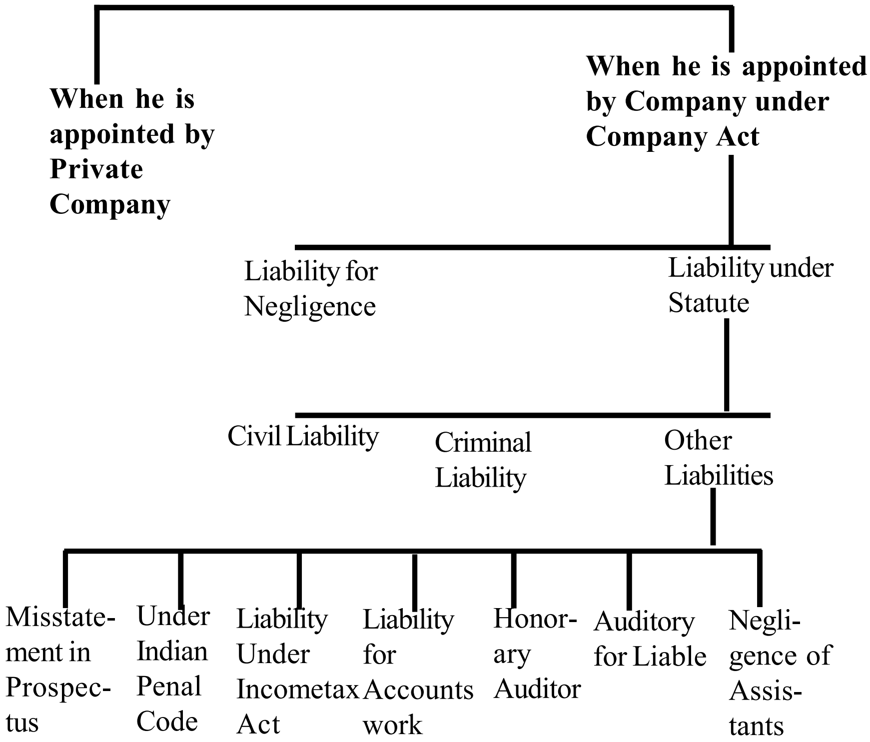
9.4 LIABILITIES OF AN AUDITOR

The Liabilities of an auditor from the legal view point may be discussed under :

a. when he is apointed by a private concern.

b. when he is appointed by a Joint Statutory Company under the companies Act A56.

Liabilities of An Auditor



Liability of an auditor when he is appointed by a private concern:

It is not obligatory for a private concern to appoint an auditor. But if he is appointed by a private concern his duties and liabilities are not defined by any Act. His duties powers and responsibilities depend upon the agreement which is entered into between him and his client. In other words his liability is contractual ability. So the auditor should get definite instructions in writing from his client. If according to instructions the auditor does not examine any books of accounts which he was not required to examine and consequently his client suffers any loss the auditor is not liable. he can be sued only under the contract Act in failing to perform his duties as liad down in the agreement. Even if no agreement was entered into be must show as much skill as is expected of such a person otehrwise he will be responsible nor the damage is constitute such a liability are

a. He must be negligent

b. as a result of negligence a loss is caused

c. the loss is suffered by the person who employed him.

He is expected to show more skill and deligence than a few decades back. Hence some of the decisions given in the past do not hold good now. Example: In the Kingsten Cotton Mills case the auditor could defend himself against the charge of negligence, if he depended upon the certiicate regarding the value and quantity of stock given by the trusted officials of the company but such is not the case today.

The Liability of an auditor under the Company Act

In case of an auditor of a limited company the Company's Act defines his duties and liabilities etc. The liability of an auditor under this head may arise form

1) Liability for negligence under the law of agency.

2) Liability under the statute

a) The Company Act 1956 either civil or criminal

b) Indian Penal Code.

Liability for negligence under the law of agency :The auditor may be sued in a civil court for damage arising out of negligence in the peformance of his dueties. For instance when dividend has been paid out of capital. An auditor is appointed to detect frauds errors etc. If an account of negligence he has failed to do so an consiquently the company suffers a loss, the auditor is held responsible for damage. In the case of agent who does not show as much skill is the performance of his duty as a result of his negligence the principal sufers a loss the agent must compensate his principle under the law of agency. Similarly if an auditor fails to show as much skill, he must sufer the consequence as was decided in the case of Hudson Vs Official Liquidator, Dehra Dun Mussorie Electric Tranway Company. Again in the case of commissioner of Income Tax Vs G.M.Dewdekar, The Auditor was held liable for negligence in not verifying the cash in hand. In other case when the auditor did not submit the audit report in time to enable the client to fulfil the statutory requirement (Lakshmi Narain Sazena).

The Auditor is not liable even though the Company has suffered a loss, if it can be proved that he was not negligence in the performance of his duties. So the other hand even it is proved that the auditor was negligente in the peformance of his duty he can not be held liable for damages of the Company has not suffered any loss due to his negligence as was held in the case of Liver Pool, and Wigan Supply Association Ltd., 1907. In such a case he can not recover the fee payable to him and the ground that he was negligent.

Therefore in order to hold the auditor liable for negligence it must be proved.

a) that he was negligent

b) as a result of his negligence the clieat suffered a loss and

c) that the loss was suffered by the person to whom the auditor owed a duty.

9. 4.1 Civil Liabilities under the Companies Act

The Companies Act puts both civil and criminal liabilities of an auditor. In a number of situations, the auditor may be liable for negligence or misstatements. For Instance:

1. Under Sec.2(30), the term ‘officer’ includes an auditor for the purposes of Secs. 437, 438, 539, 543, 545, 621, 625 and 633, implying thereto that an auditor will be liable under these sections as an officer of the company.

2. Section 62 makes an auditor liable for misstatements in the Prospectus.

3. Section 233 makes an auditor liable to penalties for non-compliance with certain provisions concerning the audit of company’s accounts, i.e. non-compliance with Secs 227 and 229.

4. A Court of law has powers to prosecute an auditor under Secs477 and 478.

5. Section 539 makes an auditor subject to a criminal liability whenever fraudulent flasification of books is carried out by the officers of the company including the auditors.

6. Under Section 628 an auditor is liable for penalty for false statements.

7. Section 545 permits prosecution of delinquent officers, the auditors and the members of the company in the court of winding up.

8. Section 621 lays downs that except the offences under Sec.545, an offence under the Companies Act will be cognisable only on a complaint in writing by the Registrar of Companies, a shareholder of the company, or a person authorised by the central government.

Liability for Misfeasance

Misfeasance means breach of duty. The Company Act impases certain duties on the auditor of the companies. If an auditor commits a bread of such a duty, he is guilty of misfeasance and is therefore liable to pay damages if his client has suffered any loss on account of his negligence. An auditor of a Company is not only liable for misfeasance when he is acting as the auditor of the Company but he is also liable in certain cases when he is no more that auditor of the Company or even when the Company is under liquidation.

In case the Company has gone into liquidation it is the liquidator who can proceed against the past or the present auditor for having committed a breach of duty otherwise the Company can proceed against him.

9.4.2 Criminal Liabilities of An Auditor

Criminal Liability of an auditor arises out of an act constituting a crime when an auditor wilfully makes any voucher or document [sec 628 & sec 538]. Under [sec 533] the court has powers to relieve an auditor to a case against him in proceding for negligence or breach of trust.

Criminal liabilities of an auditor arise because of offences against the statutory provisions. It may arise because of some criminal acts on his part of gross neglect of some provisions of the Companies Act. In all such cases, the auditor is liable not only to the shareholders but to the State as well. Criminal liabilities may emerge becuase of criminal neglect, actual fraud or conspiracy of the auditor. When charged with a criminal liability, an auditor is punishable with fine or imprisonment or both. A company auditir may be guilty of criminal offence under the following sections of the Companies Act.

1. In terms of Sec.63, an auditor is criminally liable for any untrue statement in the prospectus. He shall be punishable with imprisonment for a term which may extend to two years or with fine which may extend to Rs.5,000 or with both

2. In terms of Sec.233, if the audit report does not give the required information as under Sec.227 or if it is not signed as in accordance with Sec.229, the auditor or any other signatory is punishable with fine up to Rs.1,000, if the default is wilful.

3. If the auditor does not give the required assistance to an inspector appointed by the central government, the auditor is punishable with imprisonment up to six months or with fine up to Rs.2,000 or with both (sec.240).

4. If on the rpeort of an inspector, the central government prosecutes any person connected with the company, the auditor should asist in the prosecution, otherwise punishable as if he were guilty of contempt of court (Sec.242).

5. When a company is wound up by the court, the auditor is supposed to be present and subject himself to a private examination by the court and is also liable to return to the court any books or documents concerning the company in his possession. If he does not comply accordingly, he can be arrested (Sec.477).

6. The auditor of a company in liquidation can be publicly examined in the High Court if so applied by the Official Liquidator. The notes so signed by the auditor in the court may be used in evidence against him in proceeding - civil or criminal. (Sec.478)

7. An auditor can be held criminally liable, if with the intent to defraud or decieve any persons, he (a) destroys, multilates, alters, etc. any books, papers or securities, or (b) makes or is privy to the making of any false or fraudulent entries in any register or books of account or document belonging to the company. And if convicted, he can be imprisoned for a term which may extend to seven years besides being also liable to a fine (Sec.539).

8. The court may direct the liquidator of a company which is wound up by or under supervision of the court to prosecute the auditor, if he has been found guilty of any criminal offence (Sec.545)

9. An auditor is liable for crimianl prosecution, if he in any return, certificate, Balance Sheet, prospectus, statement or other document required by or of the purpose of the Act, makes a statement (a) which is false in any particular material knowing it to be false.

9.4.3 Other Liabilities

1. Liability for Misstatements in Prospectus

Under Sec.62, an auditor will be liable to pay compensation to every person who subscribes for any shares or debentures on the faith fo the prospectus for any loss or damage sustained becuse of an untrue statement made by him as an expert.

2. Liabilities under the Indian Penal Code

section 197 of the Indian Penal Code provides that whoever issues or signs any certificate required by law to be given or signed or relating to any fact which such certificate is by law admissible in evidence, knowing or believing that such certificate is false in any material point, shall be punisable in the same manner as if he gave false evidence. Section 177 of the Indian Penal Code prescribes simple imprisonment up to six months and / or fine up to Rs.1,000 for furnishing false information.

3. Liability under Income Tax Act

Income Ta Act prescribes rigorous imprisonment for a person who abets or induces, in any manner, another person to make and deliver to the income-tax authorities false account, statement or declaration relating to any income chargeable to tax which he knows to be false.

4. Liability for Accounts Work or Unaudited Statements

An auditor is sometimes engaged to carryout accounts work without any audit work. Such engagement have considerable risks for the auditor in as much his name may be usually deemed to indicate that the financial statements or accounts so prepared have been audited whereas in fact they have not been audited at all. A layman may not follow the full implications of the phrase 'unaudited' and may be influenced by the association of the auditor's name with the accounts. In view of diversified practices used by auditors, the contractual obligations of the accountant with his client remain undefined.

5. Liability of an Honorary Auditor

An honorary auditor has no defence under absence of consideration whenever he is charged to be responsible for negligence or misfeasance. An audit work whether paid or unpaid remains an audit. An auditor cannot be given the licence to escape hsi liability on the grounds that the contract is void in view of his not charging anything from the client for his audit work.

6. Liability of Auditors for Libel

An auditor can make a bonafide libelious or slanderous statement. However, if the auditor, while making such a slanderous statement, has actually crossed the scope of his duties, he would be liable even for a bona fide libelious statement.

7. Liability for Negligence of Assistants

The law prohibits an auditor to escape his liability on the gorunds that the said act of negligence or misfeasance was done by his assistants and not by himself. An auditor cannot shift the responsibility on to his assistants. he would personally be liable for any dereliction of duty or absence of care and skill in the performance of an audit.

8. Liability of an auditor to third parties

The question arises whether an auditor can be held liable for damages to third parties if they suffered any loss by relying upon any Balance or any statement signed by him. it is argued that as there is no privity of contract between the auditor and the third party the auditor owes no duty to such a third part and hence he can not be held liable. he is never appointed by the third party and therefore he has nothing to do with such a party as was decided in the case of Le Lievre and Dennes Vs Gould 1893. This question came before a united states court in the case of Ultra mares Corporation Vs. Touche Niven & Company in 1931. In this case a banxer advanced loans to a company on the strength of the Balance Sheet of the Company which had been signed by the auditor. The lender last the money as the Balance Sheet was misleading and fradulent. Therefore the lender sued the auditor for damages.

The plaintiff must prove all the points discussed under the Dery Vs. Peex case Viz:

1. that the statement was untrue in fact
2. that the person making it knew that it was untrue
3. that the statement was made with intent
4. that the plaintiff should act upon it
5. that the plaintiff did act in reliance in it and suffered damages.

In the case of Commissioner of Income Tax Vs. G.M.Dandekar it was held by Ayyar J. that the auditor does not owe any duty to the third party. But it may be stated here that since the decision in Hedley Byrene Company Ltd. Vs. Heller and Partners Ltd. in 1963 the auditor decisions in previous cases that the auditor does not owe any duty to third parties do not hold good now. In the other hand if a misleading statement had been made in a prospectus is sued by a Company and if the auditor had authorised the issue of such a prospectus, he can be held liable for damages to the third party which had purchased the shares of the Company on the basis of such a misleading statement even though they might not have been privity of contract between the two [sec 63].

9.5 SUMMARY

Thus an audtor undetakes a job which is responsible as well as accountable not only to his client but to others as well. An auditors rights are statutory ones and connot be avoided or curtailed in any way by any resolution or even under a provision in the Articles of Association. The duties of an auditor are necessary to submit report which is end result of the Audit Programme. On the other hand he can be held liable and called upon to pay the damages it they prove fraud and wilful or misconduct on the part of the auditor.

9.6 GLOSSARY

Misfeasance	Breach of duty
Expert	Includes amongst others an accountant and any other person whose profession gives authority to a statement made by him.

9.7 SELF ASSESSMENT QUESTIONS

Five Marks Questions

1. What are the rights of an auditor.
2. What are the liabilities of an auditor under Income Tax Act 1961
3. What are the liabilities of an auditor under Chartered Accountants Act 1949

Ten Marks Questions

1. Explain rights and duties of an auditor.
2. Describe Civil Liabilities of an auditor.

Twenty Marks Questions

1. Describe briefly Auditors rights, duties and liabilities.
2. Explain different types of liabilities of an auditor.

9.8 BOOKS RECOMMENDED

1. Practical Auditing	Tandon
2. Auditing - Principles, Practices and Problems	Jagadish Prakash
3. Auditing Theory and Practice	Paradeep Kumar
4. Principles of Auditing	R.G.Saxeena

- Dr. K. Kanaka Durga

Lesson - 10

AUDIT REPORT

10.0 OBJECTIVES

After studying this lesson you should be able to understand.

→ What is an Audit Report

→ How to prepare Audit Report

→ What are the types of Audit

→ What are the features of good Audit Report

Structure

10.1 INTRODUCTION

"A Report is nothing but a statement of facts", An Auditor's Report is the formal result of all the effort that goes into an audit. Communicating the auditors findings to interested users is part of all audits. Thus, the final phase of an audit involves preparing that communication, which is known as the auditor's report. It presents the results of the examination done by the auditor. An audit involves collection of evidence about the financial statements. The conclusions drawn are communicated to the interested parties through the auditor's report.

According to J.C.Roy. "The Report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons there for should be stated. In all cases, where Auditor's name is associated with financial statements the report should contain a clear cut indication of the character of the auditor's examination if any, and the degree of responsibility he is taking".

According to 'Lancaster' Audit Report is "a statement of collected and considered facts, so drawn up as to give clear and concise information of persons who are not already in possession of the full facts of the subject matter of the report."

The information set forth in it should be written in clear and concise words. There should be no room for any ambiguity. Further, the facts and informations which have been incorporated therein are to be conveyed to those persons who do not possess full facts.

Importance of Auditor's Report

The language and words used in audit report are of great importance. The importance of the auditor's report can also be gauged from the following points.

1. Auditor's report is essential for the shareholders of a Company as they do not possess full facts about it.

2. It is the management who are in possession of full facts abou the company's affairs and they may present a wrong picture in their own interest.

3. An independent opinion about the financial affairs of the Company is essential to the Government to impose tax.

10.2 OBJECTIVES OF AUDIT REPORT

A report is a statment of collected and considered facts, drawn up so 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. In this context the preparation of report should have the following objectives.

a. To disclose facts without any inference or interpretation.

b. To give complete and informative disclosures as required under law to the management.

c. To give clean opinion in his report.

d.. To give suggestions to the management in managing accounts according to Company Act, 1956.

10.3 CONTENTS OF THE REPORT

Under section 227(2) every auditor is required to make report to the shareholders on the accounts examined by him and every balance sheet and profit and loss account and on every document declared by law to be part of or annexed to the balance sheet and profit and loss account which are placed before the shareholders of the Company at the general meeting during the tenure of his office. An Auditor should state in his report whether -

1. i. In his opinion and to the best of his information, the accounts give the information required by the Act.

   ii. The Balance sheet and the profit and loss account give a true and fair view of the state of Company's affairs as at the end of its financial year.

   iii. He has obtained all the information and explanations were necessary for the purpose of his audit.

iv. In his opinion, proper books of accounts as required by law have been kept by the company so far as appears from his examinations of those books and proper returns adequate for purposes of his audit have been received from branches not visited by him.

v. The Company's Balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

2. The auditor's report shall also include a statement on such matters as specified by the Central Government under clause 4A of Section 227 of the Companies Act, 1965. According to this section the auditor's report shall also include a statement on specified matters.

3. The auditor's report shall not state that those account have not been properly drawn up on the ground merely that the company has not disclosed certain matters if -

i. those matters are such as the Company is not required to disclose by virtue of any provisions contained in this or any other Act, and

ii. those provisions are specified in the Balance sheet and profit and loss account of the Company.

4. He should see that the profit and loss account is annexed to the Balance sheet and the auditor's report.

10.4 TYPES OF AUDIT REPORT

The auditor's report should contain a clear and written expression of opinion on the financial information. In order to express such an opinion, the auditor should review and assess the conclusions drawn from the audit evidence obtained by him. An opinion may be clean or unqualified, adverse or qualified, or oen not being able to formulate an opinion. The report may be short or long. it may be in the form of a letter or a mere statement. Usually Audit report is prepared in two types. They are -

1. Clean Report

2. Qualified Report

10.4.1 Clean Report

The auditor gives a clean report when he is completely satisfied that there is nothing objectionable in the books of accounts and the Balance Sheet and the profit and loss accounts exhibit the true and fair view of the state of the financial affairs and earnings of the concern. In India, most of the audit reports submitted by the auditors, are clean or qualified. They simply give statutory affirmations without any objection or reservation. Such practice is probably due to the fact that management agree to make the modification in the accounts as desired by the auditors are clean or qualified. They simply give statutory affirmations without any objection or reservation. Such practice is probably due to the fact that management agree to make the modification in the accounts as dessired by the auditors before the report is submitted. The report may be given in the form given below :

Specimen of Clean Report (or Unqualified Report)

To

The Shareholders

MNO Ltd., GUNTUR.

We have audited the attached Balance Sheet of MNO Ltd. as at ..... and the statement of profit & loss account of the company for the years ended on that date, and the schedules annexed thereto and the report as follows :

We report that -

a) we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of the audit.

b) In our opinion, proper books of accounts as required by law have been kept in accordance with the standard accounting practices.

c) The Balance Sheet and Profit & Loss dealt with in the report are in agreement with the books of accounts.

d) In our opinion, and to the best of our information and according to the explanations given to us, the said accounts read with the notes thereon, give the information required by the Companies Act, in the manner so, required and give a true and fair view:

i) in the case of the Balance Sheet, of the state of affairs of the company as at .....; and

ii)in the case of Profit and Loss Account of the Company for the year ended on that date.

Date :

Guntur.

For A ,B & Co.
Chartered Accountants
Partner

10.4.2 Qualified Report

If the auditor is of the opinion that the Balance Sheet does not given a true and fair view of the state of the company's affiars or that the profit and loss account does not given a true and fair view of the profit or loss for the year, he must qualify his report accordingly. This report is known as qualified report. when an auditor is to qualify his report, he must decide -

a. to which specific matters their reseravations apply :

b. whether he actively disagrees, or on the other hand lacked sufficient evidence to enable him to form an opinion, as regards material items on the accounts.

c. Whether, in either event, the matters in question are so material as to affect the presentation of a true and fair view.

Specimen of Qualified Report

To

The Shareholders,

ABC Ltd.

We have audited the annexed Balance Sheet of the ABC Ltd. as at ..... and also the Profit and Loss Account for the year ended on that date. We report that

a) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purpose of our audit.

b) In our opinion proper books of accounts as requires by law have been kept by the company, in accordance with the accounting standards, so far as it appears from our examination of the books subject to the comments given hereunder -

i) In the absence of Stock Registers, adjustments relating to balances on the register have been accepted on the basis of the decisions of the management.

c) The Balance Sheet and Profit and Loss Account dealt with by the report are in agreemnt with the books of accounts and returns.

d) Subject to the qualification given below, in our opinion and to the best of information and according to the explanation given to us, the accounts together with the notes thereon and documents attached there to give the information required by the law and accounting standards and gives a true and fair view:

1. In the case of the Balance Sheet of the state of affairs of the company as at ____ and

2. In the case of the Profit and Loss Account of the profit for th year ended on that date.

(i) the provision for depreciation of fixed assets is inadequate.

Dated : For M.N. & Co.

Guntur. Chartered Accountants

10.5 FEATURES OF A GOOD AUDIT REPORT

1. A good Audit Report shall state -

   a. Whether the financial statements are prepared and presented in accordance with generally accepted principles of accounting.

   b. Whether such principles have been consistently followed.

   c. Whether all the informative disclosures have been adequately covered.

2. An Audit Report shall contain an expression of an opinion regarding the financial statements. If an opinion cannot be expressed, the reasons thereof must be stated.

3. It shall preferably state an indication of the extent and character of the Auditor's examination.

4. It shall disclose all material facts known to the auditor which are not disclosed in the financial statements.

5. It shall also disclose all material misstatements known to him to have appeared in the financial statements.

6. It shall clearly identify the financial statements which are under his report.

7. The report shall be addressed to the shareholders who authorise the auditor to examine and audit the accounts.

8. The date of the report shall be the actual date of completion of audit.

9. The auditor generally signs the report in the name he is registered as a practitioner.

10.6 SUMMARY

Each audit starts with an auditor and ends with his report. It is a medium through which the 'audit' function is discharged. A report is a summary of the conclusions as derived from collected and considered data in the opinion of the auditor. It is a statement of facts and a medium of communication. It communicates financial facts. The auditor's report assumes different types according to the opinion formed by the auditor.

10.7 GLOSSARY

Audit Report : Statement of financial facts

10.8 SELF ASSESSMENT QUESTION

Five Marks Questions

1. What is meant by Audit Report.

2. What is the Importance of Audit Report.

Ten Marks Questions

1. What are the contents of Audit Report.

2. What are the features of Good Audit Report.

3. What are the Types of Audit Report.

Twenty Marks Questions

1. What is meant by an Audit Report? What are the general standards of audit reporting.

2. What is a qualified report? Draft a model audit report according to Companies Act, 1956?

10.9 BOOKS RECOMMENDED

1. Text Book of Auditing - V.K.Batra & K.C.Bagardia

2. Auditing Theory & Practice - Pradeep Kumar, Baldev Sachdeva & Jagwant Singh

3. Auditing Principles, Practices and Problems - Jagdish Prakash

- Dr. K. Kanaka Durga