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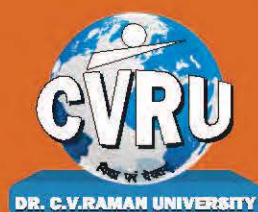
Faculty of Commerce

## Auditing

Auditing



4BCOM4



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Chhattisgarh, Bilaspur

A STATUTORY UNIVERSITY UNDER SECTION 2(F) OF THE UGC ACT

**4BCOM 4**  
**Auditing**



# 4BCOM4

## Auditing

**Credit 4**

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# **BLOCK – I**



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## LESSON

# 1

## AN INTRODUCTION TO AUDITING

### CONTENTS

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### 1.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Explain meaning and objective of Auditing
- List the features and principles of Auditing
- Discuss the scope of Auditing
- Describe the types of Auditing
- Compare investigation and Auditing

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### 1.1 INTRODUCTION

The term 'audit' is derived from the Latin term '*audire*,' which means to hear. In ancient times, the accounts were checked by hearing an accountant, while he reads over the accounts to persons. The person who heard and checked the accounts was

known as auditor. Auditing is as old as accounting. It is said to be existed in all ancient cultures such as Mesopotamia, Greece, Egypt, Rome, U.K. and India. In Indian culture, certain rules about accounting and auditing regarding public finances are mentioned in a doctrine named *Arthashastra* written by Kautilya.

Audit is performed to prove and verify the validity and reliability of information. Books of accounts are verified with the help of vouchers and documents. The verification helps in detecting and preventing an error and fraud. Expression of opinion about financial as well as non-financial zones is the main objective of an audit. Another objective of audit is to protect the financial interest of individuals related to management of a company. They can be partners as well as shareholders. The employees can be kept under a moral check through auditing. They are also prevented from fraudulent activities.

The traditional model of audit was limited to extraction and gaining information regarding a company's financial systems, transactions and record. But now along with financial areas the non-financial sectors are also being included in audit. These non-financial areas can be related to security or performance of information systems as well as concerns regarding environment.

Auditing is being performed with great pace at certain non-profit organizations as well as agencies related to government. It helps these organisations and agencies to assess their level of success in their objectives and missions.

The company accounts should be audited became mandatory under the Companies Act, 2013.

The main objectives of auditing have shifted as the sizes of the companies increased and volume of transactions also increased. So, now the objective of auditing is to make sure that the accounts of a company show truth and fairness instead of truth and correctness. Therefore, the focus is now shifted to a fairly represented financial effort rather than being accurate arithmetically. The qualification of auditors was prescribed foremost in the Companies Act, 2013.

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## 1.2 MEANING OF AUDITING

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Auditing is a process used for verifying the financial status of an organization as per its financial statements. In auditing, the accounts are analysed and examined in order to prove that the financial statements provided are true and fair in terms of the financial position, profit or loss of the business.

Through auditing, the accounting data and accounting statements are examined and tested in an intelligent and critical manner. The testing through auditing is done to prove that the data and statements are accurate, adequate and dependable.

According to Institute of Chartered Accountants of India (ICAI), auditing is defined as:

“Auditing is a systematic and independent examination of data, statements, records, operations and performance of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collect evidences, evaluates the same and on this basis, formulates his judgement which is communicated through his audit report”.

Few other definitions of auditing by some authors are provided below:

“Auditing is an examination of accounting records undertaken with a view to establishment whether they correctly and completely reflect the transactions to which they purport to relate ”

-L.R. Dicksee

"Auditing is concerned with the verification of accounting data determining the accuracy and reliability of accounting statements and reports."

- R. K. Mautz

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

- R. E. Schlosser

Following the various definitions of auditing above, we can conclude certain common aspects of auditing. These aspects are as follows:

- (i) Auditing is a way of examining books of accounts of business in an intelligent and critical manner.
- (ii) Auditing is performed by an independent qualified person.
- (iii) Certain vouchers, documents, information and explanations received from the clients are taken into consideration to carry out auditing.
- (iv) The auditor's initial action is to satisfy himself with the authenticity of the financial accounts prepared for a particular period.

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### 1.3 FEATURES OF AUDITING

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There are seven main features of auditing. These features are discussed below

1. **Auditing control:** Audit works as a tool for controlling the accounts. The auditing activities control and keep a check on the truth and fairness of accounting information.
2. **Safeguard:** The other feature of audit is to provide security on the proprietor's behalf. It safeguards the interest of proprietor against folly and fraudulent activities carried out by the agents and servants of the proprietor. They can utilise his money and assets for their own benefit.
3. **Assurance:** Apart from control and safeguarding, audit provides an assurance on the behalf of proprietor about the facts and expenditures. Audit assures that a due regularity and propriety has been considered while incurring the facts and expenditures in the accounts in true and fair manner.
4. **Assessment:** Another feature of audit is assessment. It initiates the assessment of account system to make sure that it is adequate and effective enough for the maintenance of records related to company's accounting procedure.
5. **Review:** Another feature of audit is reviewing. It helps in reviewing the financial statements. The review further initiates in acknowledging the fact that the statements truly agree with the accounting records maintained by the company.
6. **Reporting instrument:** Apart from above mentioned features, audit acts as a reporting instrument. It provides the report regarding financial statements which are required as per the terms of appointing an auditor and his agreement along with certain necessary legal compulsions and obligations.
7. **Practical subject:** The last but not least feature of auditing is that it is a practical subject. This subject has been practiced throughout the history and went through some marginal changes as per the requirement of changing era of commerce and developments in legal procedures.



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## 1.4 OBJECTIVES OF AUDITING

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There are certain objectives behind the purpose of auditing. These objectives can be broadly classified into two categories, i.e., primary objective and secondary objective. Let us discuss these objectives in detail as follows:

1. **Primary Objective:** The primary objective of auditing is governing and evaluation of financial statements and other records that support accounting of a particular financial period. It is done to know the reliability status of financial statements and other accounting records.

As per the Indian Companies Act, 1956, every organization must have an auditor appointed who is responsible for examining and verifying the books of account. The appointed auditor is supposed to provide his opinion about the reliability of audited books of account, profit and loss account and balance sheets. These three components must provide a true and fair view of all the state affairs related to the company's business.

In order to give his opinion and get a true and fair view of affairs related to the company, the auditor is supposed to go through a thorough analysis and checking of all the transactions and documents which are made during the audited period. The thorough analysis of transactions and documents helps the auditor to provide a report regarding the existing final condition and working results of the company.

The primary objective of auditing can be listed as follows:

- i. Examination of the system of internal check.
  - ii. Examination of books of accounts to check if they are arithmetically accurate. It is done by verifying the posting, casting and balancing.
  - iii. Auditing is done in order to verify that the transactions are real and valid.
  - iv. It helps in confirming that the assets and liabilities are valuable.
  - v. Auditing serves the purpose of verification that the statutory requirements are fulfilled.
  - vi. It provides the truth and fair position of accounting and financial status.
  - vii. It provides the examination about a proper distinction of capital and revenue nature of transaction.
2. **The Secondary Objective:** The second objective of auditing is to support the satisfaction of primary objective. There are two parts of secondary objective:
    - i. **Detection and prevention of frauds:** Frauds can be defined as the mistakes committed intentionally, as per the direction of top level management. There are several purposes behind the frauds carried out by management. Such as:
      - To deceive tax
      - To show that the management is effective enough
      - To get a hike on commission
      - To sell the shares of the company in market
      - To maintain the market price of shares

The auditor's main job is to detect the frauds in the company. The frauds can be any of the following:

- a. Misappropriation of cash

- b. Misappropriation of goods
- c. Manipulating the accounts or falsifying the accounts without any misappropriation
- ii. *Detection and prevention of errors:* Errors can be defined as the mistakes done unintentionally. Sometimes the financial information can be incorrect due to ignorance of accounting principle, i.e., principle errors and clerical errors (errors that arise due to negligence of accounting staff).

There are following types of errors:

- a. Errors of principle
- b. Errors of omission
- c. Errors of commission
- d. Compensating errors

So, in conclusion, the frauds and errors can be prevented by auditor by taking the following steps:

- a. Preparing an audit report of company.
- b. Providing information to income tax authority
- c. Satisfying the provision of company acts.

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## 1.5 ADVANTAGES OF AUDITING

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Auditing is a mandatory task to be performed in all companies and business organizations. Every organization including business, industries and trading etc., keeps an audit book of accounts. As the management and business owners have separate tasks to perform, thus the detection and prevention of frauds through auditing has become an essential part.

There are several advantages of auditing. Such as:

1. The frauds and errors take place in the company's management or with accounting staff, individuals can be detected easily; hence, particular steps can be taken for the prevention of any sort of loss.
2. Auditing provides a regular maintenance of accounts.
3. It facilitates in getting compensation by the insurance company in case of loss of business property.
4. It helps in getting a loan without much hassle. A company can get a loan by a financial institution on the basis of audited statements prepared in the last five years.
5. The sale of business is facilitated on the basis of audited valuations of assets and liabilities of the company. The valuation helps in determining the price of business in order to sell the company or business.
6. It provides an assessment of tax. The taxes are assessed by tax authorities on the basis of profit which is calculated by the auditor. The sales mentioned in audited statement are used by the sales tax authorities to calculate sales tax.
7. It helps in providing full-proof information of profit and loss of an organization.
8. Auditing is also helpful in increasing the goodwill of a company. The financial position and profitable status provided by auditing creates faith of people with the company or an organization.

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## 1.6 LIMITATIONS OF AUDITING

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Along with the benefits auditing is bound to certain limitations which are integral part of it. These limitations have been discussed as follows:

- (i) **Higher Cost Burden:** As the cost burden is high, it affects the scope of work in getting limited to selective testing and as a result the intensive checking of books of accounts becomes impossible for the auditor.
- (ii) **Based on Test Checks:** In general ways, the exercise of auditing is based on test checking. The concluded result of the test check may not be true always.
- (iii) **Limitation of Time:** The audit report is supposed to be released by the auditor in a specific time period. The auditor becomes constrained into a timeline for performing the auditing exercise. The inadequacy of time alters the amount of evidences related to the concerned events and transactions after the balance sheet date. As an outcome, the financial statements may be affected. The limited timeline restricts the auditor to resolve the inadequacies and uncertainties that exist in the financial statement date.
- (iv) **Inconclusiveness of Evidences:** Sometimes the evidences found by the auditor are persuasive instead of being conclusive. It means that the evidences may not provide a correct value or estimate for an asset.
- (v) **Based on Estimates:** Auditing is inherently based on estimates, which are not possible sometimes to foresee the uncertainties that may occur as an outcome.
- (vi) **Based on the Information Provided by the Management:** The only source of reliability of an audit is the information that is given by the management. Therefore, it gets difficult for an outsider to rely entirely on the report provided by an auditor.

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## 1.7 BASIC PRINCIPLES TO BE COVERED IN AUDITING

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There are several aspects of principles that must be kept in mind by the auditor during the auditing process. The following basic principle aspects can also be termed as the functions of audit:

- (i) **To review the system and procedures:** The primary function of auditing is reviewing of systems and procedures. Before going into the auditing exercise, it is necessary for the auditor to have an understanding of the system and procedures which the entity has adopted.
- (ii) **To review the internal control system:** The reviewing of internal control system is an important aspect that must be followed by the auditor. By reviewing the internal control system the auditor is able to determine its effectiveness. The effectiveness of internal control system leads the auditor in deciding to which extent the checking can be done by the auditor.

In order to determine the effectiveness of internal control system the auditor needs to perform a compliance test and substantive procedures. The effectiveness helps the auditor to perform less-checking and vice-versa.

The auditor must carry out a review of internal control system. While reviewing he can acknowledge its effectiveness, which can further enable him for determination of the limits to which the checking must be done on his part. According to Company Audit Report Order, 2003 it is important for an auditor to provide a comment on the effectiveness of Internal control system in the organization, hence reviewing of internal control is an integral part for carrying out the Auditing exercise.



- (iii) **To Check the arithmetical accuracy:** It is mandatory for an auditor to check if the books of accounts are arithmetically accurate or not. Auditor needs to carry out the checking regarding a proper posting and balances of the books of auditing.
- (iv) **To follow the accounting principles:** An auditor must confirm that whether proper distinction has been made between item of capital and revenue nature. The auditor must ascertain the fact that there has been a proper adjustment made in the books of accounts regarding the item of income and expenditures falling into a particular period.

## 1.8 TYPES OF AUDIT

There are many types of audit. They can be broadly categorised as:

1. **Based on ownership:** Audit can be of following types on the basis of ownership:
  - i. **Audit of Proprietorship:** In this case the decision to get the accounts audited is solely taken by the owner. The proprietor provides precise instructions to the auditor and an agreement is made, on which the auditing work depends.
  - ii. **Audit of Partnership:** In this type, an auditor is appointed by a mutual consent of all the partners in a company. This is done so that the misunderstandings and doubts can be avoided.
  - iii. **Audit of Companies:** As per the Companies Act, it is mandatory for every company to audit their accounts. The audit of account is the responsibility of a professionally qualified chartered accountant. Some amendments have been made in the Companies Act, 1956 and 2013 about the appointments, duties, power and liabilities of a qualified auditor.
  - iv. **Audit of Trusts:** In this case, the trustees are appointed for managing and looking after the property and business of a trust. Therefore, the access and acknowledgement of the trust can't be accessed by the recipients of the trust. The accounts of the trust are maintained as per the terms and conditions mentioned in the trust deed. Moreover, the income gets divided among the recipients of the trust. As a result of which, there may be chances of occurrence of fraudulent and misappropriate activities. Hence the trust deed and Public Trust Act helps in avoidance of such situations. As per the act, auditing of accounts of the trust must be performed compulsorily appointing a well-qualified auditor to serve the purpose. The audited accounts of the trust ensure true and fair view of accounts of the trust.
  - v. **Audit of Accounts of Co-operative Societies:** In the year 1912, Co-operative Societies Act established Co-operative societies. A Co-operative society under the audit requires its auditor to have sufficient knowledge about the particular act through which the functioning of audit is determined. It is mandatory for the auditor to acknowledge the by-laws of the society. In case there are any amendments made in the by-laws of the society the auditor must ensure that it had to be registered duly in the office of the concerned Registrar. Co-operative societies are not liable to Companies act. Hence, the responsibility of auditing and the cause to be audited lies in the hands of Registrar. He must ensure that the person appointed for audit is under his authorisation or not. The authorised person must audit the accounts of the society once in every financial year.
2. **Based on Objectives:** On the basis of objectives the audit can be of following types:
  - i. **Internal Audit:** Internal audit is related to the audit of accounts by the staff of the business. Internal audit is an appraisal activity taking place within an

organisation. Internal audit is carried out for reviewing the operations related to accounting and finance. The review further helps the management to instigate whether a protective and constructive service is being provided to them or not. This type of audit control functions by measurement and evaluation of effective status of other controls. Mainly, the accounting and financial areas are meant to be dealt with this type of audit. Yet it may sometimes deal with the matters relating to the operating nature of the organization and internal controls.

- ii. *Cost Audit:* Cost Audit is related to nature of correctness of cost accounts and verification of adherence to the cost accounting plans. The costing system, techniques and accounts are checked in a detailed manner in order to verify that the accounts are correct and ensure they obey to the purposes of cost accounting.
  - iii. *Secretarial Audit:* In Secretarial Audit, it is ensured that compliance by the company of various provisions of Companies Act and other relevant laws are verified or not. Secretarial audit report includes the following points:
    - (a) The maintenance of the books in accordance to the Companies Act, 2013.
    - (b) Obtaining the required approvals from authorities including Central Government, Company law board or other concerned authorities.
  - iv. *Independent Audit:* Independent audit is performed by an independent qualified auditor. The purpose of Independent Audit is verification of truth and fairness of the company's financial position and profits earned, by checking its financial statements. The primary purpose of Independent Audit is to provide the interest of parties such as owners, shareholders and others, a safeguard. These parties commonly cannot access the acknowledgement of the operations performed in the organization on day-to-day basis. Hence, the independent audit keeps their interest in protection.
  - v. *Tax Audit:* The tax audit has become integral so that it can be ascertained that tax related documents are accurate or not. It ensures that the tax related documents are valid and credible. In tax audit following aspects are covered:
    - (a) income returns
    - (b) invoices
    - (c) debit and credit notes
    - (d) various current and fixed assets
3. **Based on Time:** On the basis of time the audit can be of following types:
- i. *Interim Audit:* An interim audit is referred to such an audit which is performed in-between two annual audits. The accounts related to a particular part of a year are completely checked in this type of audit. It also deals with the interim figures of the sales taken place.
  - ii. *Continuous Audit:* In this type of audit, the conduction of auditing takes place at either of the following two levels:
    - (a) throughout the year, or
    - (b) regular short intervals of time.It is defined by some authors as:

"A continuous audit involves a detailed examination of all the transactions by the auditor attending at regular intervals say weekly, fortnightly or monthly, during the whole period of trading."

- *T.R. Balliboi*

"A continuous audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends at regular or irregular intervals during the period."

- *R.C Williams*

- iii. *Final Audit* When the audit work is carried out after the close of financial year it is known as the Final Audit. In general terms, Final Audit can be understood as such an audit that cannot be commenced until the financial period ends. It can be commenced once the financial period is over and completed.
- iv. *Balance Sheet Audit* In this audit, the various items of the balance sheet are verified. These items can be any of the following:
  - (a) assets
  - (b) liabilities
  - (c) reserves and surplus
  - (d) provisions
  - (e) profit and loss balance

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## 1.9 COST AUDIT, ENVIRONMENTAL AUDIT, ENERGY AUDIT

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### 1.9.1 Cost Audit

Cost Audit symbolizes the affirmation of credit reports and assesses the adherence to the cost-accounting programme. Cost Audit determines the Truth of price accounting records to make sure that they conform to price accounting fundamentals, strategies, processes, and objectives.

Cost Audit includes:

1. Verification of those price accounting records like the precision of their price reports, cost statements, price information and breaking procedure and
2. Study of those records to make certain that they stick for the price accounting fundamentals, strategies, processes, and goal.

#### *Definitions*

Cost Audit has been an essential inspection, carried out to validate the correctness of Price Accounts and also it assesses that price tag accounting fundamentals and preparation are economically adopted. It's notable that India could be the sole country that has released statutory cost audit to modulate approximately 45 critical sectors of the nation.

This expression suggests:

- (i) The items of cost-accounting gather about what the cost-accounting programme should have, now been attracted upward need to get retained at heart to check whether or not the master plan itself and also the exact amounts accumulated will contribute to the success of this target aim of collection. For example, in the event



the purpose would be to reach maximum efficacy, the master plan and also the investigation of information would differ in the circumstance at which the sole goal is always to resolve costs.

(ii) It's to be analyzed if the processes laid down to discovering costs along with different relevant conclusions happen to be executed. Treatment method and conclusion of unexpected declines of treatment or gains of particular bills as indirect or direct are examples in position.

(iii) The correctness of these characters needs to become vouched.

'Statutory Cost Audit can be a method of the audit provided by the federal government of India for its inspection evaluation and evaluation of this cost-accounting record and also extra information necessary to be kept by given businesses' (ICWA of India).

The idea of cost audit was elaborated by ICWA because of 'an audit of the efficacy of second information of cost, whereas the job is currently in advance and maybe not a postmortem assessment. A financial audit can be a 'fait accompli,' cost audit is principally a preventative step, a direct for direction coverage and conclusion additionally addition, for a barometer of performance.'

Cost Audit could be predicted as efficacy audit. It's evidenced by amendment in section 209 that reads, 'The first goal of the amendment of this section would always be to make sure given suitable company records regarding utilization of substance labour are all available that could make efficacy audit (price tag-audit) potential.'

Conduit Auditing is the procedure of "auditing the standard of supervisors via assessing these as human bosses and assessing the caliber of the entire technique of controlling within a venture." So conduit audit targets in analyzing how supervisors perform various purposes of direction, e.g., preparation, organizing, inspiring, etc.

### ***Features of Cost Audit***

The principal benefits of the cost audit that it will make certain to rely on its information because of its intentions like – price-fixing, decision and strong grip on, etc. Existence of this procedure of audit is also of excellent usage for sustaining internal control and checking. It is of excellent support to monetary audit. However, it is to be noted that the goals of the financial and cost audit differ.

The former is aimed at avoidance of errors and frauds along with a demonstration of Gain and Loss Account and Balance Sheet that demonstrates an accurate and reasonable view of this condition of events (of gain brought through the entire season and also of economic position in the close of the entire year).

It works out the totality of cost and profits in place of its operational investigation. Cost Audit will demonstrate the validity of expense of just about every item, occupation, activity, etc., and takes account of the right investigation of information and its particular estimation, therefore it receives the essential information instantly.

Aside from dependability of information, cost audit needs to yield certain significant benefits. Somewhat, it ought to be stated that cost audit helps unify and comprehend gains expected in the means of breaking. According to H R Gokhale, ex-minister of Law, Justice and Company Affairs, the societal benefit of cost audit:

'The aim with this step (cost audit) will be real to shield shoppers from unwarranted growth at price ranges. Reasonableness of those values charged may simply be guaranteed with the proper conclusion of expenses and also the perimeter billed by manufacturers as well as their retailers. Another thing underlying this measure is always to produce the businesses protected by these kinds of rules efficient and alert and also to create sure they understand their own fair cost using a view to cutting

down it into the scope potential. So by adapting for the system, the interest in consumer has been guarded plus its certain measure in the direction of removing of societal chaos'.

The benefits, temporarily, are the following:

- (i) An intimate test is going to be kept on most of the wastages – substances from a retailer, labour, etc. – and they're going to be instantly reported and located.
- (ii) Inefficiencies in a generation (or efficiencies) will probably be situated and changed to fiscal provisions.
- (iii) During fixation of human duty, direction by exclusion will undoubtedly be potential.
- (iv) The machine of financial control and standard costing will probably soon be significantly eased using cost audit in the control of an experienced cost accountant.
- (v) Records are likely to be soon update and information for assorted purposes will probably be accessible.
- (vi) Cost audit can overtake quite a few of frauds and errors that might not be shown differently. This is only because a cost auditor assesses cost caked and contrasts it together with standards and also ascertains exact causes of the discrepancy.

Cost audit provides many benefits in handling different matters to, price accountants, shareholders, statutory auditors, shoppers and also to government.

All these benefits are outlined as under:

#### ***Positive Aspects of Control:***

- (i) Glitches in after fixing fundamentals and principles are all found. Inconsistencies and scams may likewise be discovered. This prevents every one awake and boosts efficacy.
- (ii) Cost audit may function to quantify the performance of administrators along with far better performance might be rewarded.
- (iii) This will help to organize accurate price reports and also this firm preparation could be more authentic.
- (iv) Inter-firm comparisons might be built with ease, which may be quite a helpful proposal if industrial intellect is equally excellent.
- (v) Cost audit may give a notion concerning the relative operational efficacy of just about every section of the branch; also can therefore induce deficiencies and also stimulate to use within an aggressive soul.

#### ***Positive Aspects to Management/Cost Accountant***

Significant benefits include:

- (i) The task will be eased as deficiencies, mistakes, etc., are all stated. Costing ideas might be ready to manage the points.
- (ii) Cost audit can assist in the quicker understanding of financial and cost reports.
- (iii) In the event the cost auditor can be an outsider and is still an expert, then he can undoubtedly provide a few practical and solid informations to streamline dividing systems and business enterprises.

- (iv) Cost audit can help to concentrate attention directly to the problems confronted with the price accountant. This can help him to reach his targets and aims effortlessly.

***Positive Aspects to Statutory Auditor***

Important benefits include:

- (i) Audited price tag data enables him to ascertain the worthiness of shares, remuneration of managerial employees, etc., together with precision and ease.
- (ii) Statements and Data of cost audit allow him to get ready his audit programme and also plan accordingly that he focuses more on those facets that have yet to be satisfactorily insured by cost audit.

***Benefits to Consumers:***

- (i) The most primary benefit includes the way a statutory cost audit functions and resolves an affordable price tag for the shoppers.
- (ii) Considering that cost audit targets in achieving efficacy from the business enterprise, this may also have represented in lower prices towards those shoppers.

***Positive Aspects to Labour:***

- (i) In case of cost, the audit is performed entirely by labour, additionally benefits future of the persons who are involved in this process through different rewards and added benefits.
- (ii) Additionally, it provides to consider the use of labour in strengthening efficacy in the duration of greater productiveness.

***Positive Aspects to Shareholders:***

- (i) There's correct evaluation of most types of inventories. This will endeavour an actual picture of this organization before shareholders as well as different shareholders and allow them to evaluate its performance.
- (ii) Topical cost audit emphasizes efficacy or inefficiency, utilization of work as well as other tools, adequacy of yield, etc.

***Positive Aspects to Govt. and Economy:***

- (i) This enables our government to repay accounts at which cost-plus contracts are manufactured.
- (ii) The federal government might intervene to look after the interests of their shoppers, labour, shareholders, and traders in exploit or ineffective managements.
- (iii) In the federal stage, cost audit boosts cost awareness and general efficacy. It follows that every rupee spent creates the most number of merchandise and solutions.

***Kinds of Cost Audit:***

The major types of cost audit would be:

- (i) ***Cost Audit within a Support to Control:*** The goal is always to find that most information set in earlier direction is more relevant, dependable and immediate therefore that direction may release its responsibilities nicely. It also has to be found that no applicable or relevant information has been curbed.

- (ii) **Cost Audit Concerning a Person:** Regularly contracts have been positioned on "Price Plus" foundation. To put it differently, the consumer may establish that the last price tag to be compensated on the grounds of exact expense and an agreed margin of benefit. The purchaser, at this situation, commonly receives price account of this product, audited to ascertain appropriate price and for that reason, selling price.
- (iii) **Cost Audit for Government:** On occasion, the Authorities have been approached with a petition for financial support or security. Before deciding about the petition, the Authorities might decide to acquire cost account of their applicant audited, to ascertain the authenticity.
- (iv) **Cost Audit beneath Statute:** The Amendment Act of 1965 has added a fresh section, 233B, at the Businesses Act, 1956 where the Central authorities can dictate that one types of organizations will receive their price tag accounts audited using a part of the Institute of Cost and Works Accounts. Just such businesses as having to keep correct records with regards to stuff absorbed, labour as well as other bills under Section 209 (as revised up to now) and also could be asked to receive their price tag accounts audited.

The abilities and obligations and style of consultation of this cost auditor would be just like that of outside economic auditor along with the exact very same disqualifications may employ. The cost auditor will publish his account into the Company Law Board having a copy into this provider. The best way to explore all parts of price tag account is presumably given to this cost auditor.

The desire of cost audit underneath statute seems to being a tool of command, the fees of numerous merchandise. The government gets the capability to prescribe different forms at which cost audit accounts must be created. All these were created not merely to check information, but additionally to communicate a decent offer of information regarding Authorities.

- (v) **Cost Audit Concerning this Trade Association:** Sometimes commercial institutions want to keep up prices in a particular degree. For this use, the truth of breaking information filed by several worries needs to be assessed. The commerce institutions could choose to own entire information on the topic of creation capacity and also the comparative efficacy of successful procedures.

### 1.9.2 Environmental Audit

The environmental audit has been an overall term which may signify different sorts of tests designed to spot environmental compliance and administration strategy execution interruptions, together with corrective actions. Inside this manner, they perform an equal (like) role into financial audits. Additionally, there are usually two distinct kinds of environmental reviews: compliance audits and management systems audits. Compliance audits are normally the main type in the United States or within just US-based multinationals.

Environmental auditing started from the USA from the 1970s. At first reactive in attention, ecological criteria were coped with by 'end of pipe' answers. Command measures had been significantly affected from the decrease remediation expenses, and penalties which could stem from industrial injuries, also should handle environmental obligations.

Environmental auditing premiered into both UK and elsewhere chiefly by multinational companies that started initially to use the audit techniques corporately and by way of subsidiaries. It's currently being invited down the distribution series when substantial businesses require that their providers have green qualifications.

Environmental auditing has additionally been proactive because businesses have recognized potential economy along with stake holder rewards, efficacy profits, cost economies, and also the importance of enhanced public connections.

Traditionally, environmental auditing was created for industrial (compound and manufacturing) software. Further it was used in industry leading to many Charter efforts to start up activities to higher public examination. Local governments today employ auditing inside their job. This is sometimes likely to rise quickly as a consequence of new obligations in the direction of sustainable improvement and also the execution of local Agenda 2).

The expression 'environmental auditing' is extensive. Personal industry environmental auditing was variously understood to be:

The systematic study of the interactions between firm performance and its surrounding. This consists of all emissions to the atmosphere, water, and legal land limitations; the ramifications in the Arabian community, both landscape and ecology; and also the general public understanding of this operating corporation from the neighbourhood field.

Several kinds of the audit are completed out by employers:

- **Compliance Audit:** Probably the most frequently encountered kind of audit composed of tests against ecological laws and firm coverage;
- **Problems Audit:** An appraisal of the way in which a corporation's activities relate to an ecological dilemma or (e.g., worldwide contamination, electricity usage) or an appraisal of the particular dilemma (e.g., properties (provides);
- **Welbeing Insurance and Protection Audit:** An appraisal of challenges and contingency preparation (occasionally combined with environmental auditing on account of the interconnected impacts of industrial procedures and dangers);
- **Internet Site Audit:** An audit of the specific internet site to test actual or prospective ecological problems;
- **Business Audit:** An audit of the complete provider and its particular policies, constructions, techniques, and practices;
- **Business Procurement Audit:** An appraisal of future ecological and monetary hazards and obligations taken out earlier to an organization performing regular audits related to environment.
- **Activity or Functional Audit:** An appraisal of activities which can cross corporation sections or components (waste or energy direction).
- **Product or Service or Life-Cycle Audit:** An investigation of ecological impacts of the product or service during all phases of its design, manufacturing, and usage and disposal, for example, its recycling and reuse.

Those mentioned above are clarified as semi-audits related to the environment differentiate them by the more special environmental audit also, specifically, the periodic audit which forms an essential measure of ecological management systems (EMS).) Each is reviewed below.

From the community sector, community governments also have directed the manner in environmental auditing. Two forms are identified:

- **External audit:** An evaluation of the status of the neighbourhood surroundings, commonly leading to a condition of the Environment Report (SOE or SOER).



- **Internal audit:** Comprising of two locations:
  - ❖ **Plan impact evaluation:** An overview of these activities (objects and services and practices and coverages) of their jurisdiction.
  - ❖ **Conduit Audit:** A summary of these structures and procedures whereby ecological insurance policies are handled from the jurisdiction.

'Strategic Environmental Assessment' (SEA) has recently surfaced as an easy style of assessing the ecological impacts of policies, plans, and programmes. In Scotland SEA was piloted in Gordon District at 1994 SEA can be researched as an easy style of differentiating the possible ecological impacts of a few of their Structural Fund Programmes.

### *Environmental auditing practice and processes*

The more particular sort of environmental audit includes the collection, collation, evaluation, interpretation, and presentation of all information that is utilized to:

- Evaluate performance from a group of objectives or requirements, associated with certain topics;
- Appraise compliance with environmental laws and company insurance policies; and also
- Step performance contrary to certain essentials of an environmental management process benchmark.

The orderly, regular, recorded and objective elements of environmental auditing are key for efficacy. It's fast growing as an important and effective tool for the organization's ecological evaluation and direction tool kit. The demand of occasionally replicating audits makes sure that there's a continuing devotion and also a systematic course of action to boost ecological performance. The reach of repeat audits may additionally expand to eventually become a lot more comprehensive because expertise and experience will be accrued or new problems or laws arise.

On occasions, the provisions appraisal, evaluation, observation or inspection are utilized interchangeably together with the audit. The audit suggests in-depth statistical confirmation with a regular cycle amongst audits. An appraisal or inspection can be quite a one-off event that's performed in less detail and also with significantly less direct assessing of information.

Security Reviews offer a research breakdown of latest environmental results or impacts, important environmental laws plus an announcement of live ecological performance. The testimonials offer a foundation for setting up a more direct action programme. They are a part of an ecological control strategy that will help execute strategy

They need to be right to these particular conditions. As environmental auditing depends up on various modalities, every corporation can specify its own strategy predicated up on its dimension, its activities, and its particular company civilization. The extent and fashion of audits differ. However, frequent phases and activities comprise:

- Pre-audit point;
- Entire control devotion;
- Placing general objectives, goals, extent and disposition;
- Picking a staff to guarantee objectivity and expert proficiency;
- Audit point;



- Onsite audit, nicely systematic and defined with protocols or checklists;
- Inspection of files and records,
- Inspection of coverages;
- Interviews;
- Website review;
- Article-audit phase;
- Analysis of findings;
- Reporting with suggestions;
- Groundwork of an action strategy; and also
- Follow up.

That can be an increasing requirement for those consequences of auditing to become revealed. Present European centers on behalf of ecological information and also the need for this Eco-Management and Audit Scheme to allow participants to successfully release ecological announcements.

### ***Environmental Auditing and Environmental Management Systems (EMS)***

An EMS is an instrument built to allow businesses to aim, reach and establish continuous progress in environmental performance. This consists of only one incorporated direction process having a range of phases, including an environmental audit. There are a lot of criteria (e.g., the British Standard BS7750 (BSI 1992), also both the European Eco-Management and Audit Scheme for both Sector (CEC, 1993) and also the DoE Eco-Management and Audit Scheme for UK Local Authorities (DoE, 1995) etc. These include most or each of the subsequent components to:

1. Adopt an ecological coverage to support and also promote devotion to constant improvement in environmental performance;
2. Attempt an ecological evaluation to determine substantial ecological matters and impacts;
3. Put up ecological programmes of goals, objectives, and actions;
4. Set an ecological direction strategy to be sure the execution of the essential actions to attain such aims;
5. Undertake periodic estimate of elements;
6. Make one ecological announcement on ecological performance; also
7. Attain impartial confirmation of this ecological invoice.

Some businesses have established internal ecological standards that are implemented worldwide. These are stricter than nearby law.

### ***Community business environmental auditing***

More importantly, community sector bodies and community governments are adopting auditing ways to set baselines of ecological performance. These subsequently inform direction action.

Interest and action had been sparked from the late 1980s from the Friends of the Planet Earth (1989). Lots of governments willing ecological charters, follow ecological plans and action ideas that are often thought of as Green Strategies. It wasn't good comparing to previous leading policies and additionally realized that the

higher company performance and ecological added benefits of these wider and heavier methods for their internal and external auditing.

Back in 1989, the very first regional authority environmental audit has been performed by Kirklees District Council using the aid of both Friends of our planet. Ever since that time numerous Scottish Regional governments have generated environmental audits, especially Fife and Grampian Regional Councils, Ross and Cromarty, Gordon, Falkirk, Clackmannan along with Dundee District Councils. The range of community industry audits differs. The impacts of these activities of their neighbourhood jurisdiction include:

**Immediate impacts:** Ecological impacts which derive the way in which daily activities are undertaken. Direct results are insured by internal control audit.

**Assistance impacts:** Ecological impacts which lead in the businesses attempts in executing environmental procedures and aims. They'd be dealt with the coverage Impact evaluation kind of audit.

*Public industry audits protect quite a few of concentrate in places like:*

- Vitality usage;
- Recycling;
- Hard woods from renewable resources;
- Environmental instruction;
- Habitat conservation and production;
- Green paying for; and also
- Visitors are relaxing.

Inevitably you'll find problems that could happen to be missed or may be misinterpreted, and also further and better guidance is going to undoubtedly be critical

### *The Advantages of Auditing*

Even though environmental audits are made to recognize ecological problems, there can be extensively varied motives for a job and these include compliance with all laws, anxiety from providers and clients, pre-requisites from insurance or to get funding initiatives, or even to present environmental activities towards people. The advantages of environmental auditing include:

- Assuring compliance, not just together with laws, rules, and criteria, but also with business policies and also the needs of an environmental administration system (EMS);
- Allowing ecological problems and dangers to become predicted and answers intended;
- To prove that an organization knows of its impact on the surroundings through supplying opinions;
- Elevated consciousness amongst staff; and also;
- Additional effective resource usage and cost deficits.

### *Trends/future improvements*

Audit programmes are going to be a conventional ecological direction tool but problematic because of its revelation of audit answers are climbing. General public

statements of ecological information together with outside empowerment have to be people engaging from the local or European jurisdiction Eco-Management and Audit Scheme.

The usefulness of environmental audits differs from organization to organization. It's very likely that audits are going to be properly used increasingly to:

- Supply analysis information to allow businesses to appraise and take care of ecological surroundings and hazard;
- Form the cornerstone for monitoring and initiating both Environmental Management Systems;
- Subscribe to ecological direction strategies that become incorporated into ecological impact evaluation along with the managing of predicted impacts, monitoring and mitigation steps;
- Encourage the execution and direction of integrated air pollution management processes and help within the meaning of 'best practicable environmental solutions' (BPEO);
- Handle external off-road impacts that believe that the wider ecological footprint of an organization's activities; and also
- Overhaul environmentally accountable procedures down the distribution series.

Environmental audits have customarily taken care of the ecological ramifications of industrial procedures as well as to some smaller degree, together with origin ingestion. Directed from the compliance and legislation techniques, the surroundings have usually been contemplated regarding atmosphere, water and land. Substantial conservation advantages can be accomplished by broadening the attention of auditing to comprise natural legacy capabilities and objects. This will consist of natural legacy laws and from the use of audit methods to habitats and soil usage, for example as plantation components, forest management components, or even athletic property. Generic ways can result in the evolution of conservation management ideas.

### 1.9.3 Energy Audit

Energy Audit can be a critical connection within the whole direction series. The vitality director, even though suggesting a variety of classes of action and analyzing their impacts, necessitates a in-depth information foundation to perform out of energy audit efforts to successfully equilibrium the complete electricity inputs together with its own usage and functions to spot all of the energy flows inside the body and also quantifies vitality usages predicated on its distinct functionality.

An energy audit can be a fruitful device in discovering and chasing thorough energy control programmes. Its favourable attitude aiming in continuous advancement in electricity utilization compared to monetary audit that emphasizes to keep up regularity. Energy audit offers a remedy to this query -- what things to accomplish, the place you can start out, in what expense and to that which positive aspects?

An energy audit will help in vitality expenditure optimisation, air pollution management, protection elements and signals that the way to enhance the upkeep and operating practices of this body. It's instrumental in dealing with all the specific situation of the version at energy expenditure accessibility, the efficacy of power distribution, conclusion predicated on appropriate energy combination, the conclusion on utilizing enhanced electricity conservation gear, instrumentations and technological innovation.

It's been demonstrated that energy-saving of this purchase price of 1-5 to 30 per cent is potential by simplifying utilization of vitality by improved sourcing, very low priced

retro fitting steps and usage of energy efficient gear during the right time of replacements. Indian marketplace absorbs a lot more energy in comparison with its counter-parts inside the developed nations.

### ***Targets of Energy Audit***

The energy audit stipulates that the critical information foundation for total vitality conservation programme covering in essence vitality usage evaluation and analysis of all power conservation steps.

It targets in:

- i. Evaluating present blueprint of power intake at several different cost centres of surgeries
- ii. Relating vitality inputs and generation output signal
- iii. Figuring out potential regions of renewable and electric power economy
- iv. Highlighting loopholes in important locations
- v. Repairing of energy-saving potential goals for human cost centers
- vi. Implementation of steps of electricity conservation and also the realization of economies.

The general goals of this Energy Audit are executed with:

- i. Pinpointing aspects of advancement and formulation of power conservation steps necessitating no investment decision or even irreconcilable investment decision through strategy advancements and optimization of all surgeries.
- ii. Pinpointing areas needing the key investment with a combination of contemporary energy efficient equipment and also up gradation of present gear.

## **1.10 DIFFERENCE BETWEEN INVESTIGATION AND AUDITING**

Sometimes, the terms 'investigation' and 'auditing' are used synonymously. However, there is a wide difference between the two. Let us study about their differences in detail.

**Table 1.1: Difference between Investigation and Auditing**

<b>Investigation</b>	<b>Auditing</b>
Investigation infers to examine the records of a business for a particular purpose in a systematic and critical manner.	Auditing implies to examine the financial information of any entity in an independent way. The purpose of such examination is to express an opinion thereon.
It is voluntary in nature.	It is mandatory for companies but voluntary for other organizations.
It can be carried out by any person, who may not necessarily be a chartered accountant	It is mandatorily conducted by a qualified chartered accountant within the meanings of the Chartered Accountants act 1949.
Here the point of view of the appointing agency is kept in mind while the work is carried out.	Auditing is carried out on company owner's behalf.
Only the questions laid down in the engagement letter are answered.	The opinion is formed on the basis of financial statements.
There is no need of statutory form of investigation report.	The matters which are covered in an audit report are sometimes prescribed by law.

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## 1.11 CORPORATE GOVERNANCE AND AUDIT COMMITTEE

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Corporate Governance is the process through which organizations are guided and regulated for the interests of both many others as well as their stakeholders ensuring increased transparency, improved direction, along with financial coverage. The Board of Managers is accountable to the governance of these own companies.

Governance is crucial within our enterprise community now, notably following the global disasters. Company governance is recognized as a requirement enroff and to simply accept an organization generally in a lot of those stock-exchange markets all around the world. The audit committee performs a part in company governance in the management and taking responsibility of the organization. As an agent of the government mechanics and board of supervisors, the procurement committee is closely included with the organization's internal and inside audits, internal management, bookkeeping and fiscal management, regulatory compliance, and hazard administration etc., are looked after by them.

Business governance has relationships in between, and responsibility of your company's stakeholders, in addition to regulations, processes, techniques, expectations, and also fundamentals which might impact the company's leadership. Additionally, it includes assessing policies and the company's practices concerning respect for the moral criteria and fundamentals, together with the compliance of the organization.

Dramatic company failures have left it a very fundamental dilemma, with numerous authorities and regulatory governments creating attempts to put in rigorous governance regimes to guarantee the smooth functioning of business associations, and also protect against some kinds of failures. A company government process is understood to be a more-or-less country-specific period of legal, cultural and sociological facets affecting the routines of sway which investors (or stakeholders) apply on the work-related conclusion. Business governance mechanics would be the processes used, at the business level, to address corporate-governance issues.

As it's regarded as a required part of marketplace field, is tremendously required by shareholders and alternative economic market members. Regulators have enacted business government reforms to regulation in various nations, like America throughout the Sarbanes-Oxley Act of 2002 that claims that so as to protect their long term victories, associations employ company governance to be certain that they're controlled and directed at an expert, accountable and clear method. The organization government codes are fundamentals of the clinic during the stock exchange using some portion of legislature running.

### *Definition of Corporate Governance*

The phrase 'Corporate' is connected with an authorized enactment for the business' trade. The phrase 'Governance' signifies that the practice of control, direction or power. The thought of 'Corporate Governance' is that the device by that the small business entity's direction sends and controls the actions of this stakeholder's interest.

Narayana Murthy, Chairman, Committee on Corporate Governance opines----

"Corporate governance could be your endorsement by direction of their inalienable rights of investors because of the true proprietors of their business and also of the own job as trustees concerning those bankers. It's all about devotion to worth, on ethical small business behaviour and around building a differentiation between individual and corporate capital at the managing of the business."

**Problems of Corporate Governance:** Clause 49 of the listing contract addresses SEBI rules seeing Corporate Governance. Problems addressed in Clause 49 concerning Corporate Governance are:

- (i) Board's Director, for example, its reimbursement;
- (ii) Provisions relating to Board's Committee such as functioning and composition of Audit Committee. That is a significant pillar of Corporate Governance;
- (iii) Control of subsidiary businesses;
- (iv) Disclosures of significant dilemmas involving related party trades, bookkeeping procedures, basic principle of danger management, bookkeeping for profits from people problems, appropriate problems, preferential problems, and so on,
- (v) Content of direction discussion and evaluation; advice for investors;
- (vii) CEO/ CFO certificate
- viii) Report of Corporate Governance and compliance credentials.

### ***Administration's Obligation***

Managements' duty for running its own business takes it to take actions to make sure the execution of their demands of corporate governance as stipulated in Clause 49 of the Listing Agreement.

Below the details of the Listing Contract is given. A company bound to apply the Demands of Clause 49 of the Listing Contract.

### ***Audit Committee under Clause 49***

The needs of Corporate Governance under clause 49 of the list deal is reviewed under.

Reputable and Separate Audit Committee [Clause 49 (II) (a)] -

Depending upon the SEBI a licensed and independent audit committee will likely be put up taking into consideration of these standards:

- (i) The audit committee will have three supervisors. Two-thirds of those associates of this audit committee will likely be independent supervisors.
- (ii) All of the members of this audit committee will likely be financially literate, and a minimum of one member will have accounting or related financial management experience
- (iii) The Chairman of the Audit Committee will be a different manager.
- (iv) The Chairman of the Audit Committee will be present in Annual General Meeting to answer shareholder queries.
- (v) The audit committee could encourage those respondents it believes right (and also particularly the thoughts of their fund work) should be found in the conferences of this committee, however, on occasions it can even meet with no existence of some executives of the provider. The fund manager, head of internal audit and also a representative of this statutory auditor would be present as invitees of this audit committee.
- (vi) The Company Secretary will act as the secretary of the committee.

The word "economically literate" signifies that the power to browse and comprehend official financial announcements, i.e., balance sheet, revenue and loss account, along with the announcement of income flows.



A participant is going to be believed to get accounting or related financial management skills whether or not she owns knowledge in accounting or finance, or necessity expert certification in accounting.

Some other comparable experience or background which leads to somebody's fiscal sophistication, including being or having been a principal executive officer, chief financial officer or other senior officer with financial oversight tasks.

***Assembly of Audit Committee [Clause 49 (II) (B)]***

The audit committee must satisfy no less than four occasions at a calendar year and also not greater than four weeks will likely discriminate between two encounters.

The quorum will likely be either two members or a third of those associates of this audit committee whatever is increased, however, there needs to really be at the minimal of two members.

***Powers of Audit Committee [Clause 49 (II) (C)]***

The audit committee will have abilities, which ought to incorporate the subsequent:

1. To research any activity within the terms of reference.
2. To Seek out advice from every worker
3. To get external legal or other expert information.
4. To secure the attendance of outsiders.

It might be said that the four abilities as stated previously are simply illustrative rather than exhaustive.

The auditor must assess if the conditions of reference to this audit committee have been styled citing the abilities. It's compulsory for its four forces to become vested from the Audit Committee. The Board could delegate/vest forces that are additional.

***Part of Audit Committee [Clause 49 (II) (D)]***

The use of this audit committee will incorporate

- (i) Oversight of this provider's fiscal reporting procedure as well as the disclosure of its financial information to be sure that the statement is accurate, sufficient and credible.
- (ii) Reviewing with management the yearly financial statements before submission to the Board, focusing mostly on:
  - ❖ Any changes in accounting guidelines/and clinics;
  - ❖ Significant accounting entries based on exercise of conclusions by direction;
  - ❖ Qualifications in draft audit document;
- (iii) Substantial adjustments caused by audit;
  - ❖ The major concern premise;
- (iv) Compliance with accounting criteria;
- (v) Compliance with inventory trades and also a lawful requirement as to financial announcements.
- (vi) Any other connected party transactions.
- (vii) Reviewing with the management, internal and outside auditors, the adequacy of the internal management programme.

- (viii) Assessing the adequacy of an internal audit feature such as the arrangement of this internal audit department, staffing and seniority of their officer heading the department, reporting structure coverage and frequency of internal audit.
- (ix) Discussion with internal auditors any major findings and follow up thereon. Assessing the findings of any evaluation by the internal auditors into matters and reporting the issue.
- (x) Discussion with external auditors before the audit starts, character and range of audit, in addition, to have article audit discussion to ascertain any area of concern.
- (xi) Assessing the organization's economic and risk management guidelines.
- (xii) Now to research the explanations for substantial defaults in the payment to the depositors, debenture holders, shareholders (in the event of non-refundable of announced dividend) and lenders.
- (xiii) Carrying out every other role as can be said from the conditions of reference to this Audit Committee

The definition of "related party transactions" will have exactly the exact significance is included from the Accounting typical 18, Related Party Transactions, issued from the National Institute of Chartered Accountants of India.

In case the organization has put up an audit committee according to section 292A of the Companies Act, the provider insists the audit committee will possess such as can be found within the Listing Agreement.

#### ***Features of this Audit Committee***

The Audit Committee performs many significant purposes, for example, exploring the things called the plank, talk internal management, etc.. The subsection 7 and 6 of Section 292A are hereunder define the purposes of this audit committee:

The Audit Committee must have negotiations with all the auditors occasionally regarding internal management methods, the reach of an audit involving the observations of their auditors and examine that the half yearly and yearly financial statements before submission to the Board and also guarantee compliance with internal management procedures.

The Audit Committee will possess jurisdiction to research any subject regarding those items given within this section or called this from the Board as well as also for this intent, will possess full accessibility to advise within the data of the organization and outside qualified information if needed.

#### ***Inspection of Advice from Audit Committee***

***The Audit Committee will mandatorily examine the Subsequent advice according to Clause 49 II (E):***

Management discussion and analysis of financial condition and results of operations;  
Audit Committee under Section 292 a I of those Companies Act, 1956.

All businesses need to setup in Audit Committee at Compliance with clause 49 of the Listing Contract. That can be along with this development of Audit Committee under section 292. Some number of the Companies Act, 1956, of which will be summarized beneath, the characteristics:

***Section 292 some number of the Companies Act, 1956 offers:***

- (1) Every employer having paid up funding of not more than five crores of rupees will make up a committee of the Board referred to as "Audit Committee" which will contain not less than just three supervisors and this quantity of different supervisors as the Board can determine if that two-thirds of this complete quantity of participants will be supervisors, apart from controlling or whole-time managers.
- (2) Every Audit Committee included beneath sub-section will behave in compliance with conditions of reference to be given on paper from the Board.
- (3) The participants of this Audit Committee shall select a chairman from one of themselves.
- (4) The yearly record of this company will disclose the makeup of this Audit Committee.

***Audit Committee***

An Audit Committee is simply a questionnaire organized by all the Board of Director's of their company that is entrusted with the ability to oversee the practice of monetary management of this venture for example topics associated with audit review and function of fiscal coverages, hazard management coverages, etc..

Introduction of the Committee is placed under clause 49 of the listing contract and section 292. Some number of the Companies Act, 1956 in regard to given businesses in India has attracted to a noticeable shift in the financial reporting procedure because auditors finally have the chance to create forth audit - relevant topics to their interest BOD, chiefly consisting of non-executive or individual manager for making certain successful Corporate Governance.

The next further prerequisites are given according to Clause 49 of the Listing Deal where Section 292A (about audit committee) is hushed:

- (i) The audit committee could encourage those respondents, since it believes right (and also notably mind of their fund job) should be there at the end of this questionnaire, however, occasionally, it can likewise meet with no existence of some executives of the provider.
- (ii) The business secretary will become a secretary.
- (iii) The audit committee will meet no less than twice annually. The difference between two encounters must not be more than just four or four months.
- (iv) The quorum of this audit committee will likely be two associates or among those associates of this audit committee whatever is increased and the least two separate supervisors exist.
- (v) The forces and character in this audit committee are elaborately found in Clause 49 II (C) and
- (vi) Each of members of this audit committee will likely be financially literate, and a minimum of one member will have accounting or related financial management skills.

The subsequent further conditions are given according to Section 292A the Companies Act, 1956 (about audit committee) where Clause 49 of the Listing Contract remains hushed:

- (i) The audit committee contained shall behave in accordance on paper from the Board, to be given.

- (ii) The tips on this audit committee about any subject concerning financial direction, for example, audit document, will likely be binding to the Board.
- (iii) When the Board will not acknowledge the tips of this audit committee, it will list the motives and convey such factors for the share holders.

The audit committee consists of 3 members that are minimal. Even the auditor must ascertain if two-thirds of those members of the audit committee are independent supervisors and if all members of the audit committee are financially literate and a minimum of one member has accounting or related financial management skills.

The word "economically literate" signifies that the capacity to browse and comprehend simple financial announcements, i.e., balance sheet, revenue and loss account, along with the announcement of income flows.

Even the auditor must have fulfilled four occasions and also not over four weeks have elapsed in between two meetings.

The auditor must ascertain if the Chairman of the Audit Committee can be an unaffiliated manager. The saying "independent manager" was discussed at Clause 49 (J) (A) (iii)

The auditor needs to ascertain in your common yearly assembly (herein after called as AGM) presence novel along with moment's novel perhaps the chairman of this audit committee has been present in such interview to respond investors' questions.

The AGM of the year that's underneath audit would be held following this auditor filing the certification of compliance with conditions of corporate governance.

Even the auditor must ascertain if there's a custom of encouraging the executives (and also notably the mind of their fund role) from the audit committee encounters plus he needs to likewise ascertain in the moments publication of this audit committee if these executives failed to attend that the audit committee encounters. His existence in these audit committee meetings (under Section 292A) could be demanded just if he's been encouraged to, professionally provided notice of these interviews.

The auditor must determine from your moment's publication of this audit committee, while the fund manager, head of the internal audit consultant of this statutory auditor if demanded had been present since invitee from the conferences of this audit committee.

The change to Listing contract together with the Companies Act, 1956 regarding ministry audit committee underscores the need for audit procedure as well as its particular participation into the corporate governance procedure. Clause 49 stipulates that the consultant of that auditor, if demanded, will likely show up within an invitee for those encounters of this audit committee. Section 292A of the Companies Act, 1956 stipulates that all the internal auditors and the auditors, if any, and also person who is in charge of the fund will likely enroll in and participate in meetings of this Audit Committee. However they will not be able to vote.

Even the auditor is notifying the audit committee on topics related to all the audit so often, they could donate greatly in aiding and counseling the audit committee by the petition of their audit committee, especially at advancing corporate governance, supervision of financial reporting procedure, execution of accounting procedures and methods, compliance with accounting requirements, strengthening of their interior management methods in respect to economic reporting and coverage procedures.

Even the auditors are devoting expert period in helping the direction and also the audit committee to help it discharge its functions effortlessly and also in the certificate of conditions of corporate governance.

Even the auditor needs to bear in your mind that his job isn't to induce corporate governance by making certain compliance with their prerequisites of corporate governance. It's the direction obligation for making certain the same and he'd play a part in helping the direction for ensuring specifications of corporate governance.

### ***Auditor's Obligation***

The Auditor's accountability in certifying compliance with conditions of corporate governance associate with confirmation and certificate of both qualitative executions of demands of corporate governance as stipulated in Clause 49 of the Listing Agreement. Certificate and verification can be neither an audit nor an expression of comment about financial statements of the business.

The certification in the Auditor as compliance with requirements of corporate governance would be neither a certainty regarding the upcoming viability of the organization nor the efficiency or effectiveness with.

### ***General Basics of Audit***

The specifications are set out in Standards on Auditing (from now on known as SA) are appropriate in operation of a certificate of conditions of corporate governance from the Auditor, for the extent pertinent.

As in the instance of additional professional missions, in the certificate of compliance with conditions of corporate governance, the Auditor needs to comply with all the "Code of Ethics" issued from the American Institute of Chartered Accountants.

### ***Disclosures***

The Report on Corporate Governance demands disclosure of transactions with trades or connected events, which might perhaps not function as 'arm's length' trades. The auditor must verify if the advice has been placed by the direction before the Audit Committee.

The trades necessary to be revealed from the direction are beneath:

- Transactions with connected parties, both enter into at the normal path of organization should be divulged in outline type (divides them to comprehensive sorts of the trades).
- Transactions with connected parties that usually do not collapse over the standard small business trades (and so are therefore not covered in (a) above) would be supposed to be divulged separately if this kind of trades is materials trades.
- Transactions who have any get together (associated or differently) that aren't regarded because arm's length transactions, should be divulged separately if these trades are substance trades.

The auditor needs to check if or not a trade is an affiliated party trade depending on AS 18 (Related Party Disclosures). According to AS 18, functions are thought of as relevant if at any moment throughout the coverage period one party gets the capacity to restrain the party or exercise considerable influence on another party for making operating conclusions. With the goal of carrying further confirmation, mention could be forced to SA 550 (Associated Professions).

Materiality is contingent upon the dimensions and temperament of this thing. Foundation of connected party trades Clause Forty-Nine IV (a):

- (i) An announcement in outline type of transactions with connected parties from the standard plan of the organization will likely be placed on the audit committee.
- (ii) Details will likely be set before the audit committee.



- (iii) Information on material patent trades with relevant functions or some other, that are maybe not within the arm's length foundation needs to be set ahead of the audit committee, along with administration's rationale for exactly the same.

#### ***Disclosure of Accounting cure Clause 49 IV (B)***

At which case of financial announcements, remedy not the same as that approved within an Accounting regular has already been followed closely, that the truth will be disclosed within the financial statements, along with all the direction's rationale concerning the reasons it considers that remedy cure is significantly more representative of this authentic and acceptable perspective of this inherent firm trade within the Corporate Governance Report.

Inside this respect, the auditor needs to reference Sections 21-1(3B), 217(2AA) and 227 of the Companies Act, 1956. Also, the auditor needs to refer to this CEO/CFO certificate supplied below Clause 49 (IV).

#### ***Board Disclosures***

*Possibility direction Clause 49 IV:* The business will set out approaches to educate Board members concerning the hazard evaluation and minimization methods. These processes will likely be assessed to make certain that hazard is controlled by direction through the way of a framework.

#### ***Report on Corporate Governance Depending on Clause 49 (VI)***

- (i) There will be the section on Corporate Governance at Company's Yearly Reviews, using a compliance report on Corporate Governance. Noncompliance of almost any necessary necessity, i.e., that will be a portion of this Listing Deal with good reasons thereof as well as the point to that the no mandatory requirements are adopted should be particularly emphasized.
- (ii) A compliance report shall be submitted by the firms over 1-5 days by the closing of the quarter on the inventory trades. The analysis will probably be signed by the company's Chief Executive Officer and also the Compliance Officer.

The auditor must ascertain perhaps the Board of supervisors have comprised within the yearly report of the corporation, another section on corporate governance having a comprehensive compliance report on corporate governance.

This would highlight non-compliance of almost any necessary condition. (i.e., that can be an element of this Listing Agreement). Together with reasons thereof and additionally the degree to that the non-mandatory requirements are embraced. The auditor should check if the listing of list and items of all conditions according to Clause 49 are incorporated in accounts.

Any information on the report on corporate governance shouldn't be inconsistent with that.

#### ***Auditors' Certification***

By the list arrangement of Clause 49 (VII) that the firm will get a Certification in the Auditor of this organization as to compliance with conditions of Corporate Governance and annex the Certification with all the administrators' Report that is delivered yearly to all of the investors of the provider. The Certification shall be transmitted to the stock exchange.

***Undesirable or Competent Record:*** Determined by the truth and situation, a few cases might need a detrimental or competent announcement or perhaps a disclosure without



necessarily rendering it an issue material of eligibility inside the Auditors' Certification, regarding compliance with requirements of Corporate Governance, e.g.,

- (a) Non-executive directors' less than 50 per cent of Board of directors' potency.
- (b) An audit committee isn't put up.
- (c) Even the chairman of the audit committee isn't a different manager.
- (d) The audit committee doesn't fulfill four times every year.

The vital abilities when it comes to Clause 49 II (D) of this Listing contract have not been vested from the Board at the audit committee.

Enough period difference between two Board conferences is significantly more than just four weeks. A manager is a part more than ten committees across all companies.

#### Check Your Progress

Fill in the blanks:

1. When the audit work is carried out after the close of financial year it is known as the \_\_\_\_\_.
2. Auditing is mandatorily conducted by a \_\_\_\_\_ within the meanings of the Chartered Accountants Act, 1949.
3. \_\_\_\_\_ infers to examine the records of a business for a particular purpose in a systematic and critical manner.
4. \_\_\_\_\_ appraisal activity which takes place within an organization in order to review the accounting, financial and other operations as basis for protective and constructive service to the management.
5. An auditor must confirm that whether proper distinction has been made between \_\_\_\_\_ and \_\_\_\_\_.

### 1.12 LET US SUM UP

- Auditing is a process used for verifying the financial status of an organisation as per its financial statements.
- As per ICAI, "Auditing is a systematic and independent examination of data, statements, records, operations and performance of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collect evidences, evaluates the same and on this basis, formulates his judgement which is communicated through his audit report".
- Audit acts as a reporting instrument. It provides the report regarding financial statements which are required as per the terms of appointing an auditor and his agreement along with certain necessary legal compulsions and obligations.
- The primary objective of auditing is governing and evaluation of financial statements and other records that support accounting of a particular financial period.
- The secondary objective of auditing is detection and prevention of frauds and errors.
- Auditing is also helpful in increasing the goodwill of a company. The financial position and profitable status provided by auditing creates faith of people with the company or an organization.

- The only source of reliability of an audit is the information that is given by the management. Therefore, it gets difficult for an outsider to rely entirely on the report provided by an auditor.
- The effectiveness of internal control system leads the auditor in deciding to which extent the checking can be done by the auditor. In order to determine the effectiveness of internal control system the auditor needs to perform a compliance test and substantive procedures.
- Types of audit can be broadly categorised on the basis of ownership, time and objectives.

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### 1.13 LESSON END ACTIVITY

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“Independence of an auditor must not only exist in fact, but should also appear to exist to all reasonable persons”. Discuss and prepare a presentation considering this statement and highlight the advantage of independent audit.

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### 1.14 KEYWORDS

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**Audit:** The term ‘audit’ is derived from the Latin word ‘audire’, which means to hear.

**Auditing:** It is a process used for verifying the financial status of an organisation as per its financial statements.

**Cost Audit:** Cost Audit symbolizes the affirmation of credit reports and assesses the adherence to the cost-accounting programme.

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### 1.15 QUESTIONS FOR DISCUSSION

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1. Define auditing.
2. What is the need of auditing?
3. What are the features of auditing?
4. Explain the objectives of auditing.
5. What are the benefits and limitations of auditing?
6. Describe the types of auditing.
7. What are the differences between auditing and investigation?

#### Check Your Progress: Model Answer

1. Final audit
2. Qualified chartered accountant
3. Investigation
4. Internal audit
5. Item of capital; revenue nature

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### 1.16 SUGGESTED READINGS

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A. Kumar, R. Sharma, *Auditing: Theory and Practice*, Atlantic Publishers and Distributors, New Delhi.

S. K. Basu, *Auditing: Principles and Techniques*, Pearson, New Delhi.

Ravinder Kumar, Virender Sharma, *Auditing: Principles and Practice*, PHI Learning, New Delhi.

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## LESSON

# 2

## AUDIT PROCESS AND PROGRAMME

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- 2.0 Aims and Objectives
- 2.1 Introduction
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- 2.5 Audit Working Papers
- 2.6 Audit Evidences
- 2.7 Preparation before Commencing an Audit
- 2.8 Audit in Computerised Environment
- 2.9 Let Us Sum Up
- 2.10 Lesson End Activity
- 2.11 Keywords
- 2.12 Questions for Discussion
- 2.13 Suggested Readings

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### 2.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Explain the meaning of audit process
- Discuss the meaning and types of audit programme
- Explain the importance and relation between audit and books
- Describe about working and evidences about audit programme
- List out the steps of preparation before audit is commenced

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### 2.1 INTRODUCTION

In every organization, it is mandatory to perform auditing by a qualified professional, auditor. Auditing is carried out on the basis of certain processes and steps. Audit process is the initial stage of auditing. It is carried out for making a plan, obtaining the needed evidences and finally concluding with an audit report.

After the audit process, an audit programme is conducted as per suitable for the type of organizations. The audit programme is not same for every organization, thus there are two kinds of audit programmes, i.e. fixed audit programme and flexible audit programme. Any of these can be taken into consideration as per the suitability of the organization. Auditing is based on account books and other relevant documents, on the basis of which working papers and evidences to perform audit programme are created.

In the following lesson, the audit programme is discussed in detail along with its advantages and disadvantages. Furthermore, working papers and evidences are also described in details along with the steps that must be taken before the commencement of an audit.

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## 2.2 AUDIT PROCESS

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Audit process is carried out by engaging an auditor in an organisation. During the auditing process the auditor obtains knowledge of client's business. On the basis of that, the auditor formulates an audit plan and programme. The auditor determines NTE (Nature, Timing and Extent) of fundamental procedures. The fundamental or substantive features which are performed are based on the results of compliance procedures.

The audit process can be listed in the following steps:

### *Step 1: To prepare a plan:*

The auditor formulates the overall plan on the basis of the knowledge obtained about business of the client. This plan is called audit plan.

After formulation, the auditor prepares a detailed audit programme. In the audit programme, every aspect is covered.

### *Step 2: Perform procedures and obtain evidences:*

In this step the auditor has to perform following actions:

- Examination of system of internal controls.
- Determine the NTE of substantive procedures on the basis of above examination.
- Conduct the vouching of transactions and verify the balances.
- Ensure that the information is disclosed appropriately.
- The financial statements must be examined in terms of form and content.
- Ratios and trends which are significant must be analysed.

### *Step 3: Conclude and report*

In this step the auditors have to form a conclusion on the basis of evidences collected through above steps. Based on their conclusion, they are supposed to form a report of financial statements. The report must justify the truthfulness and fairness of financial statements.

Moreover, it must be ensured that the report complies with the necessary statutory requirements. Finally, the report is commuted to the appropriate authority.

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## 2.3 AUDIT PROGRAMME

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An audit programme is defined as a set of instructions for an auditor so that audit can be followed in a proper manner. The audit programme contains certain steps and procedures in a detailed written manner. It is generally a manual that determines what,

and how much evidence must be collected and evaluated. The audit programme provides the responsibilities to be taken in to consideration by the whole audit team and divides the task among the team members.

The audit working papers documents an official records in which the planning and execution of audit agreement is contained.

### **2.3.1 Types of Audit Programme**

There are two types of audit programme, i.e., fixed audit programme and flexible audit programme. These types and their advantages are discussed as follows

#### ***Fixed Audit Programme***

Commonly, the audit programme is prepared by the auditor on the basis of suggestions and recommendations provided by the assistant staff. This type of audit programme is restricted to any changes in between the auditing plan is carried out. This type of audit programme can be changed forcibly only because of pace of time or change in the situation and size as per the needs of the client. Fixed audit programme can be performed in all kinds of organizations.

The advantage of fixed audit programme is that it saves time and cost, since the work gets completed within the specified time frame, because the audit programme is restricted to any sort of change as per the request of assistant staff. The other advantage of fixed audit programme is that as the responsibilities of the auditor's assisting staff are fixed and divided, it facilitates them to complete their work in the provided amount of time. This results in the preparation and presentation of audited report on time.

#### ***Flexible Audit Programme***

Flexible audit programme can be defined as an audit programme which is subjected to change according to the need, time, and nature of business and auditing standards. There is a scope of review as per the recommendations and suggestions of the assistants. The factors such as change in number of work, nature of business, change in management and their feelings can be taken into consideration for changing the audit programme. In flexible audit programme, the assistants have the freedom to use their knowledge, intelligence and calibre.

The advantage of flexible audit programme is its effectiveness because of changes which can be made in the nature of nature and size of business.

### **2.3.2 Advantages of Audit Programme**

There are several advantages of auditing programme. Some of the advantages are listed as follows:

1. All the important aspects to be covered during an audit are ensured by the audit programme.
2. In audit programme the work distributed among the assistants is done as per their experience and competence. Thus the work load lessens and results in a better performance at the end.
3. The scope of misunderstandings decreases due to the proper instructions provided by the audit staff.
4. The progress of the work can be assessed through determining the portion of audit work has been completed or left.
5. Audit programme is helpful in serving as evidence in case of negligence.
6. After the audit is completed, the audit record may be used in future as a reference.

### 2.3.3 Limitations of Audit Programme

The limitations of audit programme are as follows:

1. **Inflexible and rigid:** After the completion of audit report, a particular audit programme becomes rigid and its flexibility is lost. Since each type of business or organization face unique and separate problems, thus a same audit programme is not possible to be used for every business or organization.
2. **Reduction in efficient staff's initiative:** It diminishes the inventiveness of proficient people. An assistant do not have any authority to recommend any improvement in the plan.
3. **Mechanizing of audit work:** The audit programme becomes so automatic that it disregards most of other features such as, internal control.
4. **Probability of ignorance of new areas:** There may be an emergence of new problems. These problems get unnoticed during the audit programme, with the passage of time.

## 2.4 AUDIT AND BOOKS

As discussed earlier, auditing is a process to verify the financial statements and books of accounts of an organization or profession. The books of accounts are audited before filing Income Tax Return (ITR). Let us study more about auditing of books of accounts.

It is compulsory for some assessees of income tax to audit their books of accounts by a chartered accountant as per the section 44AB of the Income Tax Act, 1961. Some of these assessees and the conditions in which they need to conduct audit of their books of accounts are as follows:

Assessee	Conditions (Assessment Year 2017-2018)
Businesses	In a business, when the total sales, turnover or gross receipt for the previous year exceeds Rs. 1 crore, then the books of accounts needs to be audited.
Profession	In a profession, when the gross receipts for the previous year exceeds Rs. 50 Lakhs, then the books of accounts need to be audited.
Persons covered under Section 44AD, 44AE, 44AF, 44BB or 44BBB	If a person, covered under these sections, claims that the profit and gains obtained from his business or profession is less than the profit and gains computed under these sections (irrespective of the turnover), then his/her books of accounts needs to be audited.
Persons covered under Section 44ADA	A person covered under this section needs to perform the audit of his books of accounts, if the he/she claims that: <ul style="list-style-type: none"> <li>• income from his/her profession is less than 50% of the gross receipt of the profession</li> <li>• his income is more than the maximum amount, which is not eligible for income tax in any previous year</li> </ul>
Persons covered under Section 44AD(4)	If the income of a person (carrying out a business) falling under this section is more than the maximum amount on which income tax is not chargeable, then he/she needs to audit his books of accounts.

Under the Income Tax Act, professionals are doctors, engineers, architects, lawyers, interior designers, actors and other notified professionals. In businesses, all businesses come under the purview of this Act including the traders of derivatives (future and options).

The chartered accountants are the one who audit the books of accounts of businesses and professions. An audit report is also prepared after this audit and the due date for



filing the report under section 44AB is 30<sup>th</sup> September. The businesses, professions, or persons who need not to file the audit report can submit their income tax return on 31<sup>st</sup> July.

If an assessee is not able to maintain the books of accounts according to section 44AA, a penalty may be levied. The maximum penalty charged for this is ₹ 25,000. However, if the assessee can provide a reasonable cause for failure to maintain the books along with some evidences, then the penalty can be waived.

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## 2.5 AUDIT WORKING PAPERS

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Audit working papers are the papers and documents that consist of details of accounts under audit. These papers are in the written form and they are private materials prepared by an auditor for each audit. These documents include:

- The accounting information, which the auditor has obtained from his client
- The method of evaluation used for examining the accounting information
- The conclusions derived by the auditor by evaluating the accounting information

Some of the definitions of audit working papers or simply 'working papers' are as follow:

"Working papers must include audit programme, queries, explanations given for the queries, schedules of important items like depreciation, inventories, confirmation from third parties, certificates issued by the management, banks, etc."

*- Institute of Chartered Accounts of India*

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

*- Prof. Meigs*

From the above two definitions, it can be concluded that the working paper should provide information about the:

- Planning and supervision of work
- Review of the internal control system and its reliability
- Collection of evidence and the procedures used for it
- Whether the procedures adopted provides sufficient evidence to form a reasonable basis for making an opinion or recommendation?

So, the working papers should contain a valid evidence of the work done in the current audit.

Some of the objectives of working papers are as follows:

1. The working papers act as a useful audit tool for an auditor as well as a permanent record of the audit performed by him/her.
2. They help the auditor to control the current year's audit work.
3. They consists a reliable guidance to plan the future audit assignments.
4. An examination of working papers provides an assurance that the audit is accurate and complete.
5. As the data in the working papers are arranged properly by the auditors, so, the data become more meaningful or useful for audit.

6. Working papers are essential to validate the work and the findings of the audit staff.

In general, the audit working papers include the following details:

- Schedule of debtors and creditors
- Trial Balance
- Official certificates such as bad debts, valuation of stock, unpaid expenses, accrued incomes, etc.
- Depreciation statement
- Communication between the auditor and the debtors, creditors, etc., of the client
- Investment schedules
- Confirmation from the bank about the bank balances of the client
- Bank reconciliation statement
- Important extracts from some accounting books like vendor agreement, hire purchasers, selling agents, etc.
- Detail of cash balance checked
- Adjustment entries
- Contingent liabilities certified by the management
- Financial accounts
- Details of clarifications made during the course of audit
- A copy of the auditor's book
- Letters of representation
- Correspondence from legal advisors
- Pertinent memoranda relating to the audit
- Data related to the review of internal control
- Stock holder equity and the minutes
- Test of transactions

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## 2.6 AUDIT EVIDENCES

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Evidence is the fundamental concept in auditing. Audit evidence refers to a reflection of the realities obtained during the course of an audit. All the techniques and procedures of audit are derived from the concept of evidence. It enables the auditor to determine the different types of evidences that can be obtained in a specific audit situation, collect these evidences using various audit techniques and evaluate the sufficiency and appropriateness of these evidences to support the accounting data. Therefore, the audit evidence helps an auditor to arrive at his professional judgment.

Some of the definitions of audit evidence are as follow:

“Evidence, for auditing purposes consists of nothing more than facts in some form which have an inherent objective proposition that tends to influence the auditor's mind.”

*-Willingham*

“The term ‘evidence’ includes all influences on the mind of an auditor which affect his judgment about the truthfulness of the propositions submitted to him for review.”

- *Robertson*

“Evidential matter supporting the financial statements consists of the underlying accounting data and all corroboratory information available to the auditor.”

-*American Institute of Certified Public Accountants*

The features of audit evidence are as follow:

1. An audit evidence should reflect the realities of the situation and should not be fictitious, based on imagination.
2. An audit evidence should be able to create an impact on the opinion of the auditor with respect to the truthfulness of the accounting data.
3. An audit evidence can be direct or indirect.

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## **2.7 PREPARATION BEFORE COMMENCING AN AUDIT**

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Before starting the final audit of an organization, an auditor should give the following instructions to his/her client:

1. The organization should provide the list of accounting books in use, list of employees and their duties, and internal control to the audit staff.
2. The organization should provide the books of original entry, ledgers, trial balance and final account to the auditor.
3. All the supporting documents of the accounting information should be arranged properly.
4. List and schedule of assets and liabilities should be arranged properly so that the audit staff can examine them properly.

The following work should be performed before commencing the audit:

1. **Appointment of the auditor:** The shareholders of an organization can appoint an auditor. A copy of resolution represents the management decision for the appointment of the auditor.
2. **Previous auditor:** The newly appointed auditor can write a letter to the old auditor for obtaining his consent. It is the moral duty of new auditor for informing the old auditor for appointment.
3. **Time of Audit:** The auditor can consult the management of the organization for deciding time of the audit. The accounting data for audit is fixed with the consent of management. The time allocated is used for the proper work of audit.
4. **Time required:** The auditor decides the time required for completing the audit. He/she can involve audit clerks for completing the audit on time otherwise the cost of audit increases.
5. **Audit staff:** The auditor can arrange audit staff based on the work load. There should not be extra burden of work on the audit staff.
6. **Audit duties:** The audit duties are mentioned in the audit engagement letter. In addition, the duties mentioned in the organization's ordinance cannot be overlooked.

7. **Nature of business:** The auditor should check the nature of business, i.e., whether it is a manufacturing, trading, or service organization. The knowledge of nature of business activities help in conducting audit.
8. **Business History:** The auditor should record the history of business including its year of establishment, nature, and number of products or services available in the market.
9. **Types of product:** The business should produce its different products, which are working successfully in the market. One product or service is not sufficient for competing in the market, so, the auditor should note the various types of product.
10. **List of officers:** The auditor can ask for list of officers in the organization along with their duties and specimens signature so that he/she is able to know their authorities and responsibilities. It is necessary for the completion of the audit work.
11. **Copies of documents:** The auditor can collect the copies of documents like memorandum of association and articles of association. He/she can evaluate all these documents for the purpose of audit.
12. **Books of account:** The auditor should obtain the lists of accounting books of the organization. He/she can check that the legal requirements are followed in preparing books of accounts.
13. **Internal control:** The internal control system of the organization should be tested by the auditor so that he/she can rely on it. If the organization has proper accounting and administrative control, audit sampling can be conducted.
14. **Certificates of clients:** The auditor should get the certificate from the organization and the confirmation of accounts from the debtors and creditor. The organization can issue a stock valuation certificate for the auditor
15. **Old reports:** The auditor should analyse the old audit report. He/she can determine the weakness mentioned in the previous report. He/she can check that whether the weak point mentioned in the previous report is repeated in the current year.
16. **Analytical review:** The auditor should check the ratio and percentage of a number of years to determine the trend of different accounting and financial items.
17. **Prepare report:** The auditor should prepare a report of the work performed by him/her. When the auditor is fully satisfied with the accounting books, there the report he/she submits is called clean report. If there is something wrong in the accounts, the report he/she submits is called a qualified report to the shareholders.

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## 2.8 AUDIT IN COMPUTERISED ENVIRONMENT

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These days, the organization environment is increasingly using Information technology (IT) along with computer data system (CIS) in their day-to-day procedures. That has altered the fashion how the companies work out their operations and different small business procedures. That has further contributed to shifting into the essence of audit signs created by every financial trade.

The technique of evaluation and collection of audit proof has also improvised. This demands auditors to have sufficient understanding about EDI, SDLC, CASE applications and assorted hardware and applications involved from the business enterprise

### ***Scope of Audit in CIS Environment***

The application of CIS in numerous organizations has to lead to a radical influence on audit procedures, methods, hazard involved and internal control procedures. After facets (challenges) have to be provided with due consideration when framing an audit plan which will be applied to any organization:

1. ***The Higher rate of speed and automated initiation/execution of trades:*** Within the environment of CIS, all trades are processed immediately. As soon as the trade is fed into the system, it could easily get implemented automatically without any need of authorization of the same. In the same way, studies (more elaborate ones too) may also be generated in a rather substantial rate and will be considered by multiple customers in one moment. So giving rise to a lot of security difficulties.
2. ***Uniform processing of trade, thus nontechnical malfunction:*** Even though calculating inputs, processing trades and producing sparks, the personal computer system controls multiple tests of data in each and at each time period. Furthermore, the processing of this trade is still in a consistent method. Thus the clerical mistakes made are minimised. But, there's just a change of problems against individual established mistakes involving machine produced mistakes.
3. ***Unintentional or platform generated mistakes:*** As mentioned a while ago, there's just a change in nature of problems from individual established platform made. Errors happen as a result of the absence of skilled employees. And difficulties are primarily associated with the development part, maintenance and implementing the CIS.
4. ***In experienced employees:*** Now, the most technical progress is happening at an incredibly quick tempo. It has produced a shortage of highly expertized team members to master the present technological innovation, both in client stop and auditor conclusion.
5. ***The focus of responsibilities:*** According to the CIS environment, significantly more than one sort of task/function could be executed using an individual. This also contributes to issues in segregation of responsibilities just on one human. Thus, it adds rise to numerous security concerns too.
6. ***The absence of audit trail:*** At the computerized procedure, the processing of the trade occurs immediately. Thus also results in lack of audit trail. Hence, the auditor should employ another method to compensate for the reduction in audit course.

### ***Audit Trail***

This could be understood to be a well-explained listing in which a trade could be tracked. Even the auditor will employ among these approaches to compensate for the reduction in audit trail procedure:

1. ***Special/Exceptional Reports:*** The auditor could ask your customer to set up specific accounts and print outs. E.g., some sales orders of that particular calendar month of December & March; invest in orders which happen to be short-closed from the acquiring section.
2. ***Tagging and monitoring:*** It is also a process of compensating the audit trail.
  - (a) It consists of labeling the customers' input data for example just only applicable relevant details is emphasized around the monitor, which has to become verified by the auditor.
  - (b) For example, funds payments greater when compared to a 20,000; borrowers pending for over a couple of weeks; purchase arrangement pending for over one month from the anticipated delivery day; etc..

3. **Alternative Review Procedures (ARP):** This is way to include number of approaches to pay audit trial, for example:
  - (a) **Auditors' conclusion:** Budgeting that the characters and relating them together with real statistics.
  - (b) **Ratio investigation/assessing significant ratios:** Computing certain ratios about the grounds of data previous or data time's information or info in similar businesses and evaluating them along with the real information of their customer company.
  - (c) **Screening around the overall premise:** Should human items cannot be assessed at length afterward auditor can require patches of decent chunks of information and assess so.
  - (d) **Clerical recreation:** Auditor can himself generate specified characters which were generated from the machine (which is automated).
- 4 **Usage of CAAT:** The auditor can seek the advice of either white box audit process or CAATs.

**Auditor's Involvement in SDLC and Reliance in Additional (Guide) Controllers:**

We are aware that there's a restriction of audit trail in CIS environment. So, a computerized data process lacks a sense of human reasonableness. A data approach of a company might only be more powerful if it's a decent degree of audit centers integral right into it. That's why the involvement of auditor is remarkably critical in SDLC. Moreover, the auditor can utilize certain handbook processes even while carrying out the analysis.

**Internal management environment & direction oversight:** The benefit of CIS tremendously is dependent on the participation of direction of maintenance and the development process of CIS. Below CIS setting, the probability of fraud and mistake is comparatively large. So higher direction oversight and improved internal management atmosphere are demanded.

**Usage of CAAT:** The audit as per CIS environment may not be performed via conventional (manual) procedures, effortlessly. Considering that the processing of trade in CIS setting is complex and fast, the audit has to be performed out with computer aided verification techniques (CAAT). It necessitates a pretty very good number of IT abilities within these auditors.

**Impact of Changes on Business Process**

1. **EDI:** Electronic Data Interchange, since its name implies means swap of data/information/documents out of one person to a different, digitally (using the assistance of personal computers). To put it differently, EDI may be your computer-to-computer market of documents/information in people standard arrangement. In the process of EDI framework, as soon as trade (statistics) has been fed to some pc most records have been automatically upgraded. That was not any requirement to re-ignite the info into bookkeeping method. This conserves a great deal of effort and time and empowers the mistake free trade processing system (TPS).
2. **Procedure for documenting trades:** Contrary to other manual method in which a trade undergoes a succession of measures to be able to receive listed from the main entry ledger last accounts (Balance Sheet and Profit & Loss Account). Below CIS ecosystem, those mentioned above cited three procedures are performed concurrently.



3. **Accounting/Transaction Processing System:** The CIS mechanism results in failure of the maintenance documents that are primary.
4. **Data-storage/document programme:** The data storage centers and submitting method of this organization moved through extreme changes due to fluctuations from the manner of executing business procedures.

#### ***Batch Processing (Old Theory)***

1. It's a very simple procedure and marginally just like the conventional manual programme.
2. Within this technique, trades have been processed and accumulated in both classes.
3. Within this, documents are not upgraded quickly.

For example, Accountant accumulates each of the receipts, coupons on daily basis and upgrades his new bookkeeping listing at the conclusion of the working day.

#### ***OLRT / RTOL Programme (New Principle)***

1. OLRT -- on line/real time.
2. According to this procedure, trade is processed once they can occur.
3. All these records have been upgraded simultaneously in the phenomenon of the trade.

For example, On the topic of the earnings statement, revenue ledger and buyer's ledger are all updated, mechanically.

4. Computer software packs such as Tally, SAP, etc.. in this way.

#### ***Timesharing & Support Bureau***

1. Timesharing is actually a circumstance where a single computer functions greater than one person.
2. An agency bureau is a business that procedures trade concerning its consumer business enterprise.
3. An agency bureau dealing with payroll (like ESI/PF) to get a little firm.
4. When an organization employs professional services of an agency bureau afterward, your auditor needs to get decent evidence in service of their controls exercised with the customer firm through those tasks carried out by agency bureau.
5. Now, most of the bookkeeping firms do this sort of tasks.

#### ***Flat File-system (Old Principle)***

1. Quite simply, at a set file system, end users have their particular data plus so they truly are accountable for these various data-files.
2. It contributes to info degradation and repetition of actions.
3. Attempt to visualize entry process of the govt. school, at which you're requested to fill-up a hand written type.
  - (a) On the grounds of such a sort the Admission Officer tends to make an entrance into his enroll (Book-1) also requests one to follow the costs with Cashier.

- (b) Now the Cashier requires the charges and also moves reception entrance with his money enrol (Or Book-2).
  - (c) Eventually, you introduce the money receipt to the admission officer, and also he matters you as he acknowledges your card and arranges your identity in university student's sign up (book-3).
  - (d) Afterwards, the accounts officer will upgrade their or her own accounting information (book-4) based on money guide & pupils register kept by preceding cited, 2 officers.
4. It's clear from preceding instance that just how ones' trade should get listed in 4 different group of novels stored together with different users.

#### ***Integrated Database System (New Principle)***

1. This trade is entered just one time and also the info comparable to the trade is shared with multiple customers.
2. It functions on next-generation tech / topology.
3. It includes a listing of files that are unread. After enter signal is fed out of 1 conclusion i.e., the root document (host) that has upgraded. This grasp document could be recovered by more than one consumer (customers). Thus lowers data recurrence.

For example, A man sitting at earnings division make Earnings Invoice into the own customer. Beneath this technique master records associated with Revenue and Debtors are updated automatically. The man sitting in back office can anytime assess out the Revenue information or debtors that are outstanding.

4. This type of programme is principally combined with online/real time methods.

#### ***Organisational Framework:***

There's very significant dependence on this business enterprise of CIS, now-a-days. So, there's demand for the different section (the bunch of people) to treat IT demands of this business enterprise. A Few of the employees are recorded under:

- i. **EDP Manager:** It will be in charge of all-around direction and management of this IT section.
- ii. **Statistics Administrator:** This ascertains the info specifications of various customers of data network from the business enterprise.
- iii. **Database Administrator:** It will be accountable for operational efficacy and safety of the organizational database.
- iv. **Method Analyst:** It manages this data element their end users for brand new in addition to existing uses; layouts advice system structure to satisfy the conditions; eases execution of data devices and keeps documentation.
- v. **Process code writers:** This will be accountable for up-keeping of working system (OS) applications, hardware, and network demands.
- vi. **Software Developer:** It develops innovative apps and also changes active to fulfill the information processing demands; takes away mistakes and enhances the performance of the current application programme.
- vii. **Operation Expert:** It controls and plans that the daily problems, which arise throughout the ordinary path of function, of those users of all advice.
- viii. **Librarian:** It asserts library of magnetic documentation and media.

### ***Modified Inner Command Foundation***

In CIS atmosphere as the majority of the procedures are automatic, the chances of an event of malfunction considerably raise. Furthermore, the danger of fraud is significantly high in CIS surroundings since it's less-easily identifiable. So, there's really a change in inside command foundation in CIS setting when compared with the conventional manual programme. After just two Primary Sorts of inner management needed in CIS surroundings:

### ***General EDP Controls: Overall Controls over EDP Environment***

#### ***Organisational & Management Controls***

- i. These controllers are all intended to set up an organization-wide framework to get CIS tasks. This comprises:
  - a. Planning ideal command guidelines & process;
  - b. Precisely segregating obligations between many persons.
- ii. ***System application Controls:*** These controllers are supposed to supply confidence that platform applications are developed or acquired at an untrue method. This comprises:
  - a. authorization, endorsement, testing, execution, and documentation of new system applications and platform programme alteration;
  - b. restriction of usage of platform documentation and software to authorized employees.
- iii. ***Application Method Improvement & Servicing Controls:***

All these commands are all intended to offer confidence which programmes have been designed and kept in an accredited and effective fashion and in addition to set management within:

  - a. Analyzing, transformation, execution, and documentation of how brand new revised approach;
  - b. Changes designed to software method;
  - c. Usage of platform instruction;
  - d. Acquisition of app system out of third-parties.
- iv. ***Personal computer procedure controls:*** All these assist in restraining the procedures of their computer system. They promise this:
  - a. The processes are traditionally useful for authorized purposes only.
  - b. Use of monitor functionality is confined to licensed staff.
  - c. Just authorized apps should be properly used.
  - d. Processing problems are discovered and adjusted based on timely foundation.
- v. ***Data entry & software Controls:***
  - a. Use of information and application is confined to licensed employees.
  - b. An authorization arrangement is created over trade currently being entered into the computer system.

**Control around Inputs:**

- i. All these controllers are all attracted to guarantee this:
  - a. Transactions are correctly licensed before getting processed with this personal computer.
  - b. There are decent tests installed from the input form to guarantee that the correctness of information input by the end users.
  - c. Erroneous trades are refused, adjusted of course when needed, re-submitted on a timely basis.
- ii. Get a grip on processing & info documents:

These controllers guarantee:

  - a. Transactions are correctly processed with the personal computer.
  - b. Transactions aren't missing but added replicated or improperly altered.
  - c. Processing mistakes are assessed and adjusted on a timely basis.
- iii. Get a Grip on Over Out-put:
  - a. They promise that consequences of communicating are all comprehensive and authentic.
  - b. Outputs thus established, meet the need for this person.
  - c. Use of output signal is confined to licensed employees.

***Pre-requisites even though Auditing in CIS Environment, Audit Technique in CIS Environment***

There are extreme alterations in audit procedures and methods as being a consequence of the development of CIS atmosphere. The assortment of a few of those approaches is dependent on the knowledgebase experience of Auditors. There are chiefly two methods for auditing in CIS setting which are clarified in the following:

***Black Box Strategy (Auditing on the personal computer)***

During this particular approach, the auditor is principally concerned with the Inputs fed-in from your customer and also the outcome created from the computer system. Even the auditor entirely blows off the interior processing of this information technique. By way of instance, though analyzing payroll of the business, underneath black box strategy, the auditor might first determine the whole month-to-month hours performed by picked personnel from their various timecards and he then can assess the salary/wage speed from your speed card to figure out the salary/wage payable to every worker. About the grounds of previously mentioned, the auditor ascertains their or her own output signal by assessing periods, extensions, rates, over time and strikes. At length, the auditor contrasts their or her own consequences with all the machine generated consequences.

***Whitebox Tactic (Auditing via the Computer System)***

Below this procedure, the auditor isn't merely concerned about the topic material of this audit (i.e., input signal and inputs), but also with all the interior processing of this technique. This method to comprise assorted auditing together with the support of both Audit applications and personal computer aided analysis techniques (CAAT).

This may be clarified with the assistance of after Flow-chart: Pre-prepared Out-put Signal of Client with his very own inputs & CIS CAAT.

**PC AIDED/ASSISTED AUDIT** method underneath CIS ecosystem, the auditing may not be performed efficiently with conventional/manual methods. Even the auditing throughout the computer system demands the employment of assorted audit computer software packs and a few computer aided audit procedures.

**AUDIT PC SOFTWARE USING CAAT** permits the auditor to try the reliability and trustworthiness of their customers' data platform, with no depends up on the customers' applications. There are lots of audit computer software alternatives offered with the auditors. using the assistance of that they will execute their teachings individually and effortlessly. This audit application might consist of programme apps, purpose-written apps and utility apps or method direction application. These applications are all clarified as follows:

***I. Offer Plans:***

- a. All these are generalized software bundles.
- b. These bundles have lots of generalized characteristics and utilities, and that may be applied at lots of customers' internet site.
- c. Considering these applications programmes are exceptionally generalized and can be obtained over the planet. Therefore an individual will not confront any compatibility problems. Practically all organization asserts definite amount of compatibility using those apps.
- d. For example, MS Excel are the absolute most frequently encountered case for these apps.

***II. Purpose-written Apps:***

- a. These apps are produced to carry out special natured audit endeavour.
- b. These bundles aren't readily available for purchase at the available industry. The auditor is needed to find these apps grown.
- c. Even the auditor could decorate some external bureau to come up with the app onto his own benefit (out sourcing) or else he can himself engage the developers and receive it assembled in house.
- d. While deciding upon the purpose-written system choice, the auditor has to simply take into account, the fee-related problems.

***III. UTILITY Plans:***

- a. All these apps have been utilized to do ordinary information processing purposes like sorting; sampling; assessing; generating, printing & e-mailing files/reports, etc.
- b. Though, these aren't created specifically for that audit reasons but may be exceedingly useful when doing the audit.
- c. For example, Acrobat's Adobe Reader; Microsoft Office additionally contains of specific utility apps like MS Access, MS Word, MS Powerpoint, etc

***IV. Programme MANAGEMENT Computer Software:***

- a. All these software/programmes are likewise perhaps not specially intended for audit intention.

- b. All these are effective instruments, supposed to improve the functioning of the Running process.
- c. For example, Disk Defragment, activity Manager, process Scheduler, Disk clean up, etc. are a number of the cases of machine management computer software. Employs of CAAT could be utilized to execute subsequent audit processes:
  1. ***Detail by detail and comprehensive evaluation of trades and accounts:*** The auditor can assess the trade comprehensive and at detail, so as they could choose a bigger sample dimensions. That was a good deal of time-saving, even while still employing CAAT, so he can employ additional hours and energy to reevaluate a trade.
  2. ***The software of complicated analytical inspection methods:*** This may do complex calculations and performs together with the aid of all CIS. He can pull step by step and intricate reports too to encourage his operation.
  3. ***The software of qualitative sampling methods to extract the applicable information:*** Even though extract info out of the customer's information programme, the auditor will require the assistance of sophisticated statistical and statistical processes as a way to enhance the caliber and prudence of sample chosen. The software of cognitive and statistical techniques is all but out of the question, with no assistance of computer methods. E.g., MS Excel is a programme which comprises a range of mathematical and statistical formulae and processes.
  4. ***Evaluation of overall EDP controls:*** The auditor can assess different input controls; processing controllers; output controllers; data storage, transmission and protection controllers. Even the auditor could assess the accessibility procedure and rules.
  5. ***Evaluation of Programme controls:*** The auditor can assess the operation of varied software running and installed from the computer system. Even the auditor can assess the validity of varied applications apps.
  6. ***Re-Performing processing and calculations:*** The auditor also can re-perform calculations carried out by your customer's bookkeeping strategy.
  7. ***Better coverage Procedures:*** Beneath CIS setting there are certainly a range of coverage systems can be purchased with all auditors. Even the auditor may utilize of varied graphic layouts and multimedia methods to generate his account successful, concrete and much trickier. For example, MS PowerPoint is just one of those applications applied to organize demonstrations.

Concerns in usage of CAAT when intending a consultation with the support of CAAT, the auditor should deal with the next variables:

1. ***IT experience and knowledge of this Audit crew:*** Both the auditor and the audit staff have to have adequate abilities and knowledge to take care of the audit beneath CAAT.
2. ***Access to pertinent Audit computer software and computer programmes:*** Even the auditor may utilize the CAAT and also preserve the liberty only when he's got adequate infrastructure, even the kind of computing devices and also audit applications, offered together with him. The alliance and support of this customer things employed will probably be deemed necessary.
3. ***The impracticability of Manual evolution:*** Nowadays, most businesses are embracing green procedures although carrying out the business enterprise surgeries. Furthermore, a lot of personal computer information programme



function tasks in which there's not any difficult backup proof is made. Thus which makes it more difficult for your auditor to carry out the checks manually?

4. **Powerful and Performance:** With the assistance of both CAAT, then it's likely to examine many trades together using a high degree of accuracy. This delivers efficacy and efficacy of carrying out the audit mission.
5. **Time-constraint:** The auditor must do the mission while in the restricted period duration. Whereas, a huge number of information is necessary to be preserved (for example as trade information and data) to get this brief audit period. So the auditor must earn structure for preservation and recovery of information.
6. **Detection of fraud and mistake:** The CAAT permits the auditor to programme and then perform the audit performs more efficiently together with the assistance of complex audit programme. However, below CIS setting, frauds are both deliberate and broadly speaking deep laid. Furthermore, there are opportunities that many frauds have been emphasized, however, there's not any concrete proof to show precisely the same. So it cannot be stated that the auditing throughout the personal computer increases the chances of detection of fraud.
7. **Usage of CAAT in smallish businesses:** Even in the small business enterprise, usage of CAAT may perhaps not be a cheaper and more workable option. This could be only because of 2 causes. Initially the earnings of each mission aren't too large, and also next to that the client thing may not need exactly the proper specialized infrastructure to successfully conduct CAAT.

#### ***Ways involved in App of CAAT***

After measures must be performed by the auditor in powerful use of CAAT:

1. Put the purpose of all CAAT programme;
2. Discover that the material and availability to this thing's documents;
3. *Figure out the extent:* Define the particular databases or files to be analyzed;
4. Know the connection among the info tables in which a database still to be analyzed;
5. Limit the particular tests or processes and associated trades and accounts changed;
6. Explaining the outcome needs;
7. *Arrange databases & files:* Organize together with all the consumer and IT sections, if suitable, for duplicates of those applicable documents or database tables should be created in the Ideal Cutoff time and date;
8. *Audit staff:* Define that the employees who might take part in the plan and use of CAAT;
9. *Cost efficacy:* Enhance the estimates of benefits and costs;
10. *Follow up:* Make certain that the usage of CAAT is suitably managed;
11. Set up the executive tasks, for instance, essential abilities, and personal centers;
12. Get back together information to be utilized for CAAT using all the bookkeeping and other documents;
13. Submit CAAT programme;

14. Assess the outcomes;
15. Doc CAATs to be utilized for example goals, higher degree Flow-charts and execute directions;
16. Gauge the impact of adjustments to this programmes/system in using CAAT.

### Check Your Progress

Fill in the blanks:

1. The fundamental or substantive features which are performed are based on the results of\_\_\_\_\_.
2. An \_\_\_\_\_ is defined as a set of instructions for an auditor so that audit can be followed in a proper manner.
3. \_\_\_\_\_ is restricted to any changes in between the auditing plan is carried out.
4. Flexible audit programme can be defined an audit programme which is \_\_\_\_\_ according to the need, time, and nature of business and auditing standards.
5. The books of accounts are audited before filing\_\_\_\_\_.
6. \_\_\_\_\_ are in the written form and they are private materials prepared by an auditor for each audit.
7. All the \_\_\_\_\_ of audit are derived from the concept of evidence.
8. Before \_\_\_\_\_ the organization should provide the list of accounting books in use, list of employees and their duties, and internal control to the audit staff.
9. If there is something wrong in the accounts, the report be/she submits is called a \_\_\_\_\_ to the shareholders.

## 2.9 LET US SUM UP

- Audit process is carried out by engaging an auditor in an organisation. During the auditing process the auditor obtains knowledge of client's business.
- The audit process contains the steps, i.e., planning, obtaining evidences, concluding and reporting.
- Audit programme is generally a manual that determines the extent and process for collection and evaluation of an evidence.
- There are two types of audit programmes, i.e., Fixed audit programme and Flexible audit programme.
- It is compulsory for some assessee of income tax to audit their books of accounts by a chartered accountant as per the section 44AB of the Income Tax Act, 1961.
- Under the Income Tax Act, professionals are doctors, engineers, architects, lawyers, interior designers, actors and other notified professionals.
- Audit working papers are the papers and documents that consist of details of accounts under audit. These papers are in the written form and they are private materials prepared by an auditor for each audit.

- Audit evidence refers to a reflection of the realities obtained during the course of an audit. All the techniques and procedures of audit are derived from the concept of evidence.
- Before the commencement of audit programme, the initial step is to provide the list of accounting books in use, list of employees and their duties, and internal control to the audit staff. These lists and details must be provided by the organization to the auditor.
- When the auditor is fully satisfied with the accounting books, then the report he/she submits is called clean report.
- If there is something wrong in the accounts, the report he/she submits is called a qualified report to the shareholders.

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## 2.10 LESSON END ACTIVITY

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Prepare a detailed presentation about flexible and fixed audit programme by taking up an example of two different organizations, one for each.

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## 2.11 KEYWORDS

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**Audit process:** Audit process is carried out by engaging an auditor in an organisation. During the auditing process the auditor obtains knowledge of client's business.

**NTE:** Nature, Timing and Extent

**Audit programme:** An audit programme is a set of instructions for an auditor so that audit can be followed in a proper manner.

**Audit working papers:** Audit working papers are the papers and documents that consist of details of accounts under audit in the written form. They are private materials prepared by an auditor for each audit.

**Audit evidences:** Audit evidence refers to a reflection of the realities obtained during the course of an audit.

**Internal control:** It is "the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records."

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## 2.12 QUESTIONS FOR DISCUSSION

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1. Define audit process.
2. Explain an audit programme and define the types of audit programme.
3. What are the advantages and limitations of audit programme?
4. What is the importance of audit and books?
5. Define audit working papers and list out the details they must include.
6. Define audit evidence and make a list of its features.
7. Describe how the preparation before commencement of an audit is performed.

**Check Your Progress: Model Answer**

1. Compliance procedures
2. Audit programme
3. Fixed audit programme
4. Subjected to change
5. Income Tax Return (ITR)
6. Audit papers
7. Techniques and procedures
8. Commencing an audit
9. Qualified report

**2.13 SUGGESTED READINGS**

A. Kumar, R. Sharma, *Auditing: Theory and Practice*, Atlantic Publishers and Distributors, New Delhi.

S. K. Basu, *Auditing: Principles and Techniques*, Pearson, New Delhi.

Ravinder Kumar, Virender Sharma, *Auditing: Principles and Practice*, PHI Learning, New Delhi.

## **BLOCK – II**

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## LESSON

# 3

## INTERNAL CHECK IN AUDITING

### CONTENTS

- 3.0 Aims and Objectives
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- 3.5 Let Us Sum Up
- 3.6 Lesson End Activity
- 3.7 Keywords
- 3.8 Questions for Discussion
- 3.9 Suggested Readings

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### 3.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Explain the meaning of internal check
- Discuss the meaning, advantages and disadvantages of routine checking
- Explain the meaning and adoption of test checking
- Differentiate between routine checking and test checking



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### 3.1 INTRODUCTION

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An auditor must ensure himself with a full-proof understanding of the company he deals with. Before commencing his audit, he must familiarise himself with the nature of business and then grasp the technicalities. Thus, he will be able to understand and identify the nature of transactions recorded in account books of the company. The internal control and system of internal check is operated in every organisation differently. The auditor must be able to get hold of the internal checking system of the company.

The purpose of internal check is to prevent frauds, misapprehensions, misrepresentations, errors and losses. The auditor plays a major role in internal check system of a company in detecting the misleading statements and transactions, errors and frauds and presents a fair and true view before the company about its working process. The systems of checking such as internal check, routine check and test check are operated and established by the management of the company.

In the following lesson these aforementioned systems of checking will be discussed in detail along with their different aspects, advantages and disadvantages. Moreover, we will discuss the scope of auditor's role in such checking systems in a company.

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### 3.2 INTERNAL CHECK

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Internal check can be understood as a method that helps organizations in accounts systems of a company. In a concerned business or organization several duties are assigned to the clerks. Therefore, internal check facilitates in organizing the system in such a manner that the work of one person can be checked automatically by another. This method is useful in enabling the investigation of a fraud, or any other errors and irregularity on behalf of the management and clerks.

To understand the concept of internal check, let us discuss an example of a cash receipt.

- a. Firstly, a cashier enters the receipt on the debit side of the cash book.
- b. Then the entry carried out by the cashier is entered to the ledger by another clerk.
- c. In the third step, the third clerk passes the statement of accounting regarding transactions to the customer.

Thus, in the whole procedure a cash receipt passes through three levels and the details are automatically checked by one to another clerk.

This procedure divides the labour among the workers and thus minimizes the possibility of frauds, errors and falsity.

It is important that all the employees at three levels are committed to each other for defrauding their employer.

Internal check is defined as per the special committee on Terminology, American Institute of Accountants 1949. According to it, "Internal check is a system under which the accounting methods and details of an establishment are so laid out that the accounts procedures are not under the absolute and independent control of any person – that, on the contrary, the work of one employee is complementary of that of another, and that a continuous audit of the business is made by the employees."

There are certain elements which are essential for an internal check. The elements are as follows:

- Day-to-day transactions must be checked.

- This checking must be operated on a continuous basis as a part of routine system.
- Work of one person compliments to the work of another
- In internal check the main objective is to allocate the duties among the workers in order to avoid any exclusive control of any person over the transaction.

### 3.2.1 Internal Check Regarding Cash

Majorly, in every organization, the frauds are related to cash. Thus, in case of cash transactions, it is necessary that a proper system of internal check is implemented. The following points can be considered in order to perform efficient internal check regarding cash:

- The auditor must be acquainted with the system of internal check in operation.
- The division of duties in the matter of cash must be done in such a way that checking of various functionaries related to cash section, can take place automatically.
- Other important aspect of internal check is rotation of duties. The duties of the employees related to the cash section must be rotated on a routine basis.

### 3.2.2 Internal Check Regarding Cash Receipts

Internal check regarding cash receipts can be performed by considering following steps

- It is important to keep the mail books, cash funds and ledgers inaccessible to the cashier.
- The presence of a responsible person is mandatory during the time a cashier opens payments and transfer of funds. Every cheque and bank draft that has been received must be marked as 'Not negotiable A/c Payee only.'
- Each and every receipt must be deposited in the bank by a cashier.
- A printed receipt must be issued after receiving the cash for the purpose of acknowledgement.
- The acknowledgement of cash received must be done through issuing a receipt in print.
- The receipt must have a counterfoil in order to keep a record of the transactions that are made. Every receipt must be consecutively numbered and kept in a locker.
- Use of cash registers must be made mandatory.
- The paying-in-slips must be prepared by the cashier so that the bank can retain them.
- It must be noted that the counterfoils of paying-in-slips must be entered by another clerk instead of cashier himself.
- There must be a proper organization of cash sales. It helps in minimizing the misappropriation.
- The reconciliation statements in bank must be made on a frequent basis by the cashier or any other responsible employee.

### 3.2.3 Internal Check Regarding Cash Payments

In case of internal check regarding cash receipts, following points must be kept in mind:

- Payments made by cheques must be authorized and signed by a responsible person. Before dispatching of the cheques, every cheque must be marked 'A/c Payee'.
- The cheque books which remain unused should be kept under lock by a responsible person.
- No other duties should be assigned to the employees who have authority to sign and countersign the cheques. It is important to avoid the risk of providing them any opportunity through which they can influence the entries in the ledgers.
- To maintain the unimportant or petty cash an imprest system should be considered.
- These vouchers must be maintained by proper numbering and filing them in order.
- An independent checking must be done for casting of cash books.

### 3.2.4 Internal Check Regarding Wages

Wage bills are of high importance in case of manufacturing concerns. Thus, the system of internal check is significant with regards to wages.

Following dangers must be counteracted in any system of internal check regarding wages:

- Inadequacy of time records. This causes the workers inconvenience because of receiving the wages at undevoted time.
- Inadequacy in piece work is recorded. This enables the workers to receive wages for the work which is not done on their part.
- Errors while preparing wage-sheets or pay rolls.
- Inserting the dummies in order to manipulate the wage sheet.

The suggested system of internal check varies according to each particular case.

Though, to prevent the above situations leading to any dangers, the following system of internal check is suggested:

- **Keeping a time Record:** In an organization where the wages are meant to be paid on the basis of time, it must be made mandatory to record the time of entering and leaving on part of each employee. Moreover, the head of every department must record the time of entering and leaving the department. This way of recording time initiates in counter-checking of all the records and leads to restraining the workers to waste time.
- **Maintenance of records about Piece work:** In the organizations where wages are paid according to the piece-wages, it is necessary to keep a system that can efficiently keep a record of piece work. An entry must be made in concerned piece worker's card, when the work is allotted to him/her. When the work is completed this card must be signed by the worker as well as the concerning department head and the store-keeper of the organization.
- **Prepare the wage-sheets:** There should be maintenance of wage-sheets for time workers and piece workers separately. All the essential particulars must be recorded in the wage-sheets. In the wage sheet separation of columns must be done to record the following:

- i. Gross amount payable,
- ii. Deductions for employees,
- iii. State insurance,
- iv. Provident fund contribution,
- v. Loans,
- vi. Fines
- vii. Net amount payable.

Every column must show contribution of the employer under the Employees State Insurance Act. The wage sheet must be prepared according to the following steps:

- a. The gate-keeper is supposed to keep the records for time workers.
- b. Two clerks in the wage office. In case there is any discrepancy found, it must be enquired.
- c. The particulars of an employee such as name, rate of wage etc., must be recorded by a third clerk in a wage-sheet.
- d. The particulars and records of the wage-sheet must be checked by a fourth clerk.
- e. Then, at last a fifth clerk must calculate the net amount of wages that has to be paid to the worker.

The wage sheet for piece workers is prepared in the similar manner, as given above. It must be noted that each wage clerk must prioritise the portion of work connected with wage sheet which has been undertaken by him. At last, the Works Manager, a Director or a Partner must counter sign the wage sheet.

- **Payment of wages:** In the payment of wages the cashier has a responsible role to play. To make payments of the wages proper and error free following points are important to be kept in mind:
  - ❖ There should be no role of cashier in preparation of wage sheets.
  - ❖ For a precise amount of wage, a separate cheque must be drawn out.
  - ❖ The workers must receive their wages personally.
  - ❖ To avoid the situation of impersonation of any worker, the foreman or head of department must be present.
  - ❖ In case a worker is absent during the payment of wages, he must get a letter of authority and receive his wages.
  - ❖ The presence of a Work Manager or any other responsible person is important at the time of payment.

### 3.2.5 Internal Check Regarding Purchases

The system of internal check that is adopted regarding purchases of an organization depends majorly on its size and resources. Yet, the following system of internal check for purchases can be considered:

- A purchases order book must be maintained to record all the orders for purchases. The orders must be authorized in a proper way. They should be properly authorized. The order which has been placed must have an entry in the order book of which a carbon-copy should be attained and kept.

- There has to be a record in the Goods Inwards Books by the gate-keeper or store-keeper. This book must contain the receipts of goods.
- The quality, quantity, prices and calculations of invoices received from sellers must be kept in check with the Orders Books and Goods Inwards Books.
- The clerk must check these books and have the access of invoices initially.
- After the process of checking, these invoices must be entered in a Bought Day Book and filed.
- In case the organizations have many departments and orders are placed by each of them particularly, the invoice is meant to be sent to the department for checking.
- A store ledger must be maintained where an independent person can enter the details of all the goods purchased on behalf of whole organization.
- A responsible official must authorize the payment of every invoice.
- The system of internal check for cash purchases must be operated routinely and properly.

### 3.2.6 Internal Check Regarding Sales

The possibility of errors and frauds is more in the case of sales. For example, the goods sent on approval can be treated as actual sales or a fictitious sale can be entered in the sales book.

Moreover, there is a possibility of taking the present year's sale as the next year's sale, mistakenly. In other cases, the selling of fixed assets can be entered in the record as the sale of goods. Thus, the system of internal check is important so that the above-mentioned situations can be counteracted. The following points should be considered while performing internal check regarding sales:

- There should be a proper record of all the orders which are received. It will be additional to the advantage if the records are kept in writing. Telephonic or verbally received must be confirmed in writing.
- The Goods Outward Book must be maintained in order to record all goods supplied.
- Two copies of invoice must be prepared. One must be sent to the customer and other carbon copy must be kept.
- Before sending out, the details of every invoice must be checked.
- The comparison of entries in Goods Outwards Book and invoices must be done.
- On the basis of the details in the invoices the entries must be recorded in the sales book.
- Goods returned by the customer should be entered in the returns inwards book and a credit note must be prepared. In case a customer returns the goods, the details must be entered in inwards book. Afterwards, a credit note must be prepared.
- In case of cash sales, the cash must be collected by a responsible and reliable person instead of salesman. Delivery of goods must be based on receipt cash memo.

### 3.2.7 Role of an Auditor in Internal Check

The reliability of internal check system on the part of auditor depends on the size and nature of an organization. The auditor needs to take steps mentioned below, before he decides to rely on internal check system:

1. He must ask for a statement from his client in regard of internal check system.
2. He must perform an examination and analysis of the system considering the size and nature of the business.
3. He must analyse the weakest point of internal check system in order to make an assessment about possibilities of errors and frauds.

In case the auditor finds any defect in the system of internal check, he is supposed to carry on detailed checking. The work of an auditor can be minimized to a great extent if the system of internal check is efficient. Yet his liability on the internal check system can be reduced. On another aspect, if the system is found to be defective, the work of the auditor increases and becomes difficult.

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## 3.3 ROUTINE CHECKING

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Every organization of any size, whether big or small, and operating in any industry, either manufacturing or service company, must maintain some records and accounting books that are common in all type of business organizations. These records and books are checked by an auditor on a routine basis and this is called routine checking in auditing. Routine checking involves the following tasks:

- Examining the records of primary books, costing, transfer etc.
- Examining the transfer of business transactions from original accounting books to ledger account.
- Examining the debit and credit side of different accounts.
- Examining the transfer of balances of different accounts to other pages or accounts or statements.

The objectives of the routine checking are as follows:

1. To determine the mathematical accuracy of the primary books of accounts.
2. To understand the regularity in primary books of accounts.
3. To know that the figures are not changed after the check using distinct ticks and marks.

### 3.3.1 Ticks and Marks used in Routine Checking

Different signs are used in routine checking. These signs act as the proof of routine checking of transactions.

The signs used in routine checking should be small and clear. In general, red or pink colour is used for conducting routine checking. However, green colour is used for conducting the final audit.

The signs used in routine checking are called ticks or check marks. The main points related to these signs are as follows:

1. **Precautions:** While using the ticks and marks in routine checking, the following precautions should be taken:
  - (a) The marks must be small and clear.



- (b) The marks should not have the same colour in which accounts are written.
  - (c) Various colours of marks should be used for performing different accounting activities.
  - (d) The marks should be changed each year.
  - (e) The meanings of marks should be kept secret.
2. **Place of Ticks and Marks:** It is important to decide the place for making the mark beforehand along with the colours, and the types of marks. Generally, marks are made on the left side of the amount while verifying the postings in accounts. While examining the voucher with the amount, mark is placed on the right side. For verifying the total, mark is made below the total, etc.
3. **Importance of Ticks and Marks:** The ticks and marks play an important role in the verification of accounts. While expressing the importance of Ticks & Marks, Prof. Emerson said, "during audit, Ticks and Marks must be kept in mind, in the same way as while walking, we keep track of the road in mind, while talking we keep words in mind and while shopping pocket is kept in mind. In all these situations, a little carelessness creates various problems."

### 3.3.2 Advantages of Routine Checking

The advantages of routine checking are as follows:

1. All the original entries are checked in the routine checking; thus, all the errors and frauds can be identified easily.
2. In routine checking, all the entries and posting are checked.
3. It helps in conducting the final audit as the balancing and totals of all the accounts have already been checked.
4. As routine checking is a regular process, so, a separate and specific staff is not required for performing it.

### 3.3.3 Disadvantages of Routine Checking

Despite of the above mentioned advantages, routine checking also suffers from various limitations. These limitations are as follows:

1. As routine checking is a mechanical task, so, the staff that performs this work is less motivated and inspired. Thus, there are chances that they leave errors and frauds in the audit.
2. It can only identify the small errors and frauds and not the big and planned frauds.
3. It is not required when self-balancing system is used.
4. It cannot identify the principle and compensating errors.

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## 3.4 TEST CHECKING

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In auditing, test checking can be defined as the examination of a few selected transactions from the beginning to end. In test checking, a few transactions are selected randomly from a large number of transactions. Test checking is also called "Selective Verification" or "Sampling Process".

- Test checking is a proxy for detailed checking
- Only a partial checking is involved in test checking.

- The basis of test check is, if a randomly selected transaction is found to be correct and errorless by the auditor then it can be believed that the rest of the transactions might be also be correct.

Instead of detailed checking, test checking is accepted as a substitute which is unwarranted from the economic point of view.

### 3.4.1 Adoption of Test Checking

Method of test checking depends entirely on judgment and discretion of auditor. The auditor's judgment and discretion is based on the individual cases and certain circumstances.

There may be certain dangerous consequences of performing test check, hence it is necessary to apply and carry it out with utmost care and intelligence. The two factors are for test checking:

- a. System of internal check
- b. Intelligence of the auditor

### 3.4.2 Features of Test Checking

Test checking involves two basic aspects on part of the auditor, i.e., selection and checking of proportion of transactions.

Some of the salient features of Test Checking are mentioned as follows:

1. **Scientific reason:** There is a mathematical truth about selection of a proportion from the population displaying similar features in common. It has been proved mathematically that samples selected scientifically would disclose the similar features and characteristics as displayed by the population. There is a scientific law which is the basis of this statistical theory of sampling. Hence, it is a reliable option in contrast to any other technique which may lack basis and acceptability.
2. **Estimation process:** Though it is based on scientifically an arithmetically proven basis, test checking and sampling cannot be fully reliable, as there will always be a doubt about the accuracy in results. The whole process of test checking is related to estimation.
3. **Coverage of material items:** An exhaustive checking is carried out for the entries which involve big amounts or entries and which are related to material accounts. Certain other entries apart from the above mentioned, are verified according to a certain plan. As a result, the entries get check for a specific time period and rest of them remains unchecked.
4. **Full coverage over a time period:** Generally, the planning of Test Check is organized in such a way that the audit programmes for 3 to 5 years can cover all types of transactions irrespective of the size of the company. Hence, if test checking is carried out in the months of January, June and December in a particular year then, in the next year April, July and September may be checked.
5. **Surprise Element:** In the Audit Company, the staff and management must be restricted to foresee the pattern of test checking. It is necessary in order to prevent them to predict the areas and time periods to be covered in any particular year. The restriction of staff and management also facilitates in avoiding any employee to be alert and careful regarding the checking.
6. **Flexibility:** The test checking must be flexible on part of the auditor. If test checking is carried out routinely, it becomes predictable and mechanical, hence

loses its value. Therefore, in order to avoid such circumstances, the auditor must keep changing the methods of test checking at reasonably regular intervals.

7. **Judgment Based:** The test checking is limited primarily to the judgments made by the auditor for a specific situation. His judgment for a specific situation depends on various aspects such as auditor's previous experiences, current developments in the organization and internal control system.

### 3.4.3 Advantages of Test Checking

Test checking enjoys the following advantages:

1. Time and energy is saved.
2. Test checking can only be useful and purposeful only when the transactions are selected intelligently
3. There is a reduction in the work load; hence an auditor can work simultaneously on several audits.
4. It facilitates the auditor to create a definite conclusion regarding the true and fair view of the state of affairs of the organization.
5. The cost of audit is minimized.

### 3.4.4 Disadvantages of Test Checking

Test checking suffers from certain disadvantages. The following disadvantages of test checking are:

1. All the errors and frauds are impossible to be detected.
2. The possibility of carelessness on part of the client's clerks may take place because of their acknowledgement that there will be no detailed checking of their works.
3. Though the auditor checks the whole work in detail, the suspicion and doubts remains in his mind.
4. Until and unless the systems of internal checks are improper and ineffective, and the proper controls are not being adopted in business, the process of test checking serves no purpose and hence becomes useless.
5. Test checking is not suitable and useless for small business concerns.

### 3.4.5 Difference between Test Checking and Routine Checking

The differences between test checking and routine checking are as follows:

Particulars	Test Checking	Routine Checking
Meaning	Test checking is an auditing procedure in which only some of the transactions are checked for making an opinion about all the transactions.	Routine checking is a detailed checking audit procedure. In this checking, all the transactional aspects are checked. These aspects include checking of casts, sub-casts, carry-forwards, extensions and calculations etc., in subsidiary books. Moreover, the checking is carried out for posting into the ledgers, casting of ledger accounts and extraction of their balances, etc.
Objectives	For getting a reasonable level of satisfaction regarding all transactions by verifying a few of	<ul style="list-style-type: none"> <li>• To check the arithmetical accuracy of the transactions and their entries.</li> </ul>

Contd.,

	them, which represents the other transactions. They are called "sample".	<ul style="list-style-type: none"> <li>• To check the accuracy of posting to ledgers.</li> <li>• To verify that the ledger accounts are balanced correctly.</li> <li>• To make sure that figures are not altered after routine checking.</li> </ul>
Advantages	<ul style="list-style-type: none"> <li>• Saves time.</li> <li>• Proper and careful checking helps in achieving the audit objective.</li> <li>• Reduces the volume of work.</li> <li>• Enable auditors to get time for conducting other audits.</li> </ul>	<ul style="list-style-type: none"> <li>• Verifying the posting and ledgers.</li> <li>• Verifying the arithmetical accuracy of the accounts.</li> <li>• Facilitating tallying of trial balance.</li> <li>• Making the detection of errors and frauds easy for auditors.</li> <li>• Facilitating the delegation of auditing work to junior staff.</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>• It may make the client staff careless about maintenance of accurate accounts.</li> <li>• It may leave some errors and frauds undetected.</li> <li>• All items and transactions are not checked.</li> <li>• There is an element of doubt and risk in the Auditor's opinion.</li> </ul>	<ul style="list-style-type: none"> <li>• It is a highly mechanical process.</li> <li>• It may lead to boredom as the activity is monotonous.</li> <li>• Major objects of frauds and high-level details and complications are not revealed.</li> <li>• Reimbursement of errors and errors of principle do not get recognised.</li> </ul>

### Check Your Progress

Fill in the blanks.

1. The auditor must be acquainted with the \_\_\_\_\_ in operation.
2. In internal check the main objective of is to \_\_\_\_\_ among the workers in order to avoid any exclusive control of any person over the transaction.
3. A \_\_\_\_\_ must be issued after receiving the cash for the purpose of acknowledgement.
4. Payments made by cheques must be authorized and signed by a responsible person. Before dispatching the cheques, every cheque must be marked \_\_\_\_\_.
5. \_\_\_\_\_ in order to manipulate the wage sheet is a danger to internal check system regarding wages.
6. At last, the Works Manager, a Director or a Partner must counter sign the \_\_\_\_\_.
7. The system of internal check that is adopted regarding purchases of an organization depends majorly on its \_\_\_\_\_.
8. The comparison of entries in \_\_\_\_\_ and invoices must be done.
9. The auditor must analyse the \_\_\_\_\_ of internal check system in order to make an assessment about possibilities of errors and frauds.

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10. One of the objectives of routine checking is to determine the \_\_\_\_\_ of the primary books of accounts.
11. Different signs are used in routine checking. These signs act as the \_\_\_\_\_ of transactions.

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### 3.5 LET US SUM UP

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- "Internal check is a system under which the accounting methods and details of an establishment are so laid out that the accounts procedures are not under the absolute and independent control of any person - that, on the contrary, the work of one employee is complementary of that of another, and that a continuous audit of the business is made by the employees."
- In internal check regarding cash, the division of duties in the matter of cash must be done in such a way that checking of various functionaries related to cash section, can take place automatically.
- The cash receipt must have a counterfoil in order to keep a record of the transactions that are made. Every receipt must be consecutively numbered and kept in a locker.
- No other duties should be assigned to the employees who have authority to sign and countersign the cheques. It is important to avoid the risk of providing them any opportunity through which they can influence the entries in the ledgers.
- Inadequacy in piece work records, causes the workers to receive wages for the work which is not done on their part.
- In the wage sheet separation of columns must be done so that the aspects such as gross amount payable, deductions for employees, state insurance, provident fund contribution, loans, fines etc., and the net amount payable can be recorded easily and conveniently.
- A purchase order book must be maintained to record all the orders for purchases. The orders must be authorized in a proper way. They should be properly authorized. A carbon-copy of every order placed should be kept.
- In case any customer has returned the Goods, the detail regarding return must be entered in the returns inwards book. Adding to that, a credit note should be made
- The work of an auditor can be minimized to a great extent if the system of internal check is efficient. Yet his liability on the internal check system can be reduced.
- Every organization of any size must maintain some records and accounting books that are common in all type of business organizations. These records and books are checked by an auditor on a routine basis and this is called routine checking in auditing.
- "During audit, Ticks and Marks must be kept in mind, in the same way as while walking, we keep track of the road in mind, while talking we keep words in mind and while shopping pocket kept in mind. In all these situations, a little carelessness creates various problems."
- Test checking is also called "Selective Verification" or "Sampling Process".
- Test checking involves two basic aspects on part of the auditor, i.e., selection and checking of proportion of transactions.
- Verifying the posting and ledgers is one of the advantages of routine checking.

### 3.6 LESSON END ACTIVITY

What type of internal check will you prepare in case of a manufacturing company so that frauds related to sales of goods can be prevented? Prepare a presentation covering all the aspects.

### 3.7 KEYWORDS

**Internal check:** Internal check is a system of checking that facilitates in organizing the system in such a manner that the work of one person can be checked automatically by another.

**Test checking:** Test checking can be defined as the examination of a few selected transactions from the beginning to end. In test checking, a few transactions are selected randomly from a large number of transactions.

**Invoices:** A list of goods sent or services provided, along with a statement of the sum due for these. In simple words, it can be called a bill.

**Routine checking:** The records and books of an organization are checked by an auditor on a routine basis and this is called routine checking in auditing.

**Wage sheet:** It is a combined list of workers, in which the gross deductions and net wages payable to them are mentioned.

### 3.8 QUESTIONS FOR DISCUSSION

1. What is internal check? Discuss in detail.
2. Describe the role of auditor in internal check?
3. What is routine checking? Discuss its advantages and disadvantages.
4. Define test checking and list out the features of test checking.
5. What are the advantages and disadvantages of test checking?
6. Differentiate between routine checking and test checking.

#### Check Your Progress: Model Answer

1. System of internal check
2. Allocate the duties
3. Printed receipt
4. 'A/c Payee'
5. Inserting the dummies
6. Wage sheet
7. Size and resources
8. Goods Outwards Book
9. Weakest point
10. Mathematical accuracy
11. Proof of routine checking



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### 3.9 SUGGESTED READINGS

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A. Kumar, R. Sharma, *Auditing: Theory and Practice*, Atlantic Publishers and Distributors, New Delhi.

S. K. Basu, *Auditing: Principles and Techniques*, Pearson, New Delhi.

Ravinder Kumar, Virender Shanna, *Auditing: Principles and Practice*, PHI Learning, New Delhi.

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## LESSON

# 4

## INTERNAL CONTROL AND PROCEDURE

### CONTENTS

- 4.0 Aims and Objectives
- 4.1 Introduction
- 4.2 Meaning of Internal Control
- 4.3 Types of Internal Control
- 4.4 Characteristics of Good Internal Control System
- 4.5 Internal Control and Auditor
- 4.6 Difference between Internal Control and Internal Check
- 4.7 Audit Procedure
- 4.8 Let Us Sum Up
- 4.9 Lesson End Activity
- 4.10 Keywords
- 4.11 Questions for Discussion
- 4.12 Suggested Readings

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### 4.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Explain the meaning of internal control
- Discuss the types of internal control
- Explain the characteristics of good internal control
- Describe the role of auditor in internal control
- Differentiate between internal control and internal check
- Explain the procedure of internal audit

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### 4.1 INTRODUCTION

Earlier the systems in business were considered with an aim of being the work done in cheaper and quicker ways available. With time, it was being realised that certain fragmented methods of work process have begun to take place hence the systems became inefficient and expensive. Thus, a need for an overall planning took place. The planning is done in such a way that the flow of work can be maintained and the business can run smoothly. The requirement of safeguarding of assets was added to the maintaining of the efficiency of the business.

Hence, an overall planning and its being operated practically are incorporated under the title of internal control. Internal control is established by the management. Even

though the auditor is not provided with any right for practicing any method of internal control. He is must be concerned with the system only virtually because the internal control system may have an influence in his working processes and methods.

In the following lesson, the concept of internal control system has been discussed in detail along with its types and characteristics. Adding to this, the lesson also discusses the extent of auditor's role in the internal control system. Moreover, we will discuss the difference between internal control and internal check as they may be misunderstood at times as the same concepts. The lesson will be concluded with the procedure of internal audit.

## 4.2 MEANING OF INTERNAL CONTROL

Internal control can be defined as a whole system of controls including financial and other aspects, created by the management of an organization so that the business of the organization can function in proper order. Moreover, it helps in providing safety to assets and security to the accurate and reliable records of the organization.

Hence, internal control acts as an umbrella term covering wide range of aspects. The scope of internal control can be expanded beyond its limits to such matters which involve the functioning of accounts and financial records. The scope of internal control encompasses all such matters that are related straight to the functioning of records maintained for accounts and finance.

The scope of internal control system can be concluded as following:

- It consists of control environment and procedures.
- It is extended beyond the fields of accounting and finance.
- It ensures that the business is being conducted orderly in all functional areas.
- The auditor's concern lies only to the internal controls which have direct impact on the accounting system.

Control environment is an integral part of internal control system; hence it is important to understand the meaning and factors affecting control environment.

It can be defined as the overall attitude, awareness and actions of the management with regards to internal control system and its importance in the organization.

There are three main factors which affect control environment:

Control Environment	Management Supervision	Personnel
<p>The organizational structure must be established in such a manner that no individual can dominate and influence the internal control system.</p> <p>It should provide for separation of unsuited task, so that misstatements can't be committed easily.</p> <p>For instance, the authorisation for purchase, record keeping and other functions regarding assets, must be segregated.</p>	<p>Planning and maintenance of internal control system is the responsibility of management.</p> <p>A review must be performed routinely by the management to ensure that effectiveness of internal control system is not lost.</p> <p>The management can establish a separate department called "Internal Audit" to keep a check on the effective operation of internal controls.</p>	<p>The capability and honesty of the individual is the basis of internal control system's effectiveness.</p> <p>Therefore, it is necessary that the personnel appointed for internal control system is properly qualified, trained and experienced.</p>

### 4.3 TYPES OF INTERNAL CONTROL

Generally, in internal control there are two types: preventive and detective controls. Both are crucial for effectiveness of internal control system. The difference between the two is that, preventive controls act as a proactive and highlights on the quality. On the other hand, detective controls are essential as they provide evidences through which the preventive controls can function as per the intention of the organization. These types of internal controls are discussed as follows:

#### *Preventive Controls*

The purpose of preventive controls is to discourage errors and irregularities. Its function is to prevent errors and irregularities from occurring. They help in ensuring the fulfilment of departmental objectives. Examples of preventive controls are:

- **Segregation of Duties:** Duties are divided among people to minimise the risk of error and misappropriation. Generally, this division is made for three functions:
  - a. Approval for transactions (approval)
  - b. Maintaining a record of transactions (accounting)
  - c. Supervising the assets (custody)
- **Approvals, Authorizations, and Verifications:**
  - a. The authority for performing certain activities and execution of certain transactions within a restricted parameter lies in the hands of the management. Thus, approval of management must be mandatory.
  - b. The transactions that need an approval from a supervising body must be authorised by the concerned authority. Therefore, the authorization must be made mandatory before performing any transactions and other activities by the employees.
  - c. The approval and authorization from the supervisory body infers the verification and validation of the activity or transactions carried out by an employee.
- **Security of Asset:** In this type of control, a restriction is made for accessing an equipment, inventories, and securities. Moreover, a routinely checking is performed by counting and comparing the amounts as per the control records.

#### *Detective Controls*

The purpose of detective control is to find errors and frauds that have already taken place. Examples of detective controls are:

- **Reviews of Performance:** In the process of reviewing, certain informations are compared by the management. These informations can range from current performance of the company to budgets, forecasts and other benchmarks. The purpose of comparison is to measure at what extent the goals and objectives of the organization have been achieved. Afterwards, they can make a result out of it, so that the unexpected results and unusual conditions can be identified to make a follow-up to balance the results.
- **Reconciliations:** In this type of control an employee is supposed to relate various sets of data to one another and identify the possibility of any difference. After the identification, he is supposed to make an investigation and take the necessary corrective actions

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## 4.4 CHARACTERISTICS OF GOOD INTERNAL CONTROL SYSTEM

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The characteristics of good internal control system are as follows:

- An organization must have a well-developed plan. The responsibilities must be designated properly at different levels based on operational hierarchy.
- A record must be kept regarding the maintenance of control over assets liabilities, revenues and expenses. A scientifically developed system of record procedures must be considered.
- There must be a system leading to healthy practices and traditions. This initiates a good result of performing duties and activities in every department of organization.
- It is important that the employees of an organization possess good character and an in-depth understanding of the duties and responsibilities assigned to them. They must have a proper training and ability about their designation. It is a necessary aspect as the employees are given authority to exercise controls in the organization.
- A managerial supervision is mandatory. Moreover, the organization's financial operations and positions must be revised and reviewed on a routine basis. The review can be done with the help of interim accounts, reports and summaries.

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## 4.5 INTERNAL CONTROL AND AUDITOR

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In the system of internal control, the main concern of an auditor lies in the evaluation of the internal control system established in an organization. Thus, there are a few points he may be able to know:

- An auditor can find out if the mistakes, errors and frauds are possible to found in the regular course of business.
- An auditor can acknowledge the existence of an effective internal auditing.
- He can judge the reach and adequacy of functioning of the management about the rightful record of transactions. Moreover, he can acknowledge the extent and adequacy about the discharging of management's functions which further concerns to the recording of transaction appropriately.
- He can decide at what extent he must examine the various areas of accounting.
- He can decide at what level administrative control has a bearing on his work.
- He can decide the correct audit programme in prevailing situations of the organization.
- He may be able to know the scope of reliability on reports, records and the certificates of the management.
- He is able to decide if he can give some suggestion and advices for the improvement of the existing control system.

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## 4.6 DIFFERENCE BETWEEN INTERNAL CONTROL AND INTERNAL CHECK

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Internal control is not to be confused with internal check. Both systems vary in meaning, scope and nature. The difference between internal control and internal check has been depicted in the table given below:

**Table 4.1: Difference between Internal Control and Internal Check**

<b>Internal Control</b>	<b>Internal Check</b>
Internal control is defined as a system which is executed by an organization for ensuring the integrity of financial and accounting information. It enables the organization to acknowledge progress and success of the organization regarding its profitability and operational objectives.	Internal check is defined as a way of designating and assigning the responsibilities and division of work among the employees of an organization. Internal check can be defined in a limited way as it covers many aspects of an organization.  In internal check a system is such constructed that the work of a subordinate gets automatically checked by the supervising authority. The checking proves if the work is being done as per the policies and guidelines of the company or not.
Internal check plays a vital role in system of Internal control. Whereas, internal control is a wider aspect in an organization.	Internal check has a narrow scope in comparison to internal control.
The design and documentation of internal control is created at level of corporate management.	The implementation of internal check, unlike internal control, can be done at all levels of an organization, for instance, tactical level or operational level.

Therefore, it can be concluded, that internal control is a broad term in which other systems such as internal check, internal audit, and other forms of control are included.

## 4.7 AUDIT PROCEDURE

Audit procedure can be defined as the techniques, tactics and steps undertaken by the auditor to assess, review and identify the inefficiencies in the company's operation. It is done for cost reduction and achievement of organizational goal.

Internal check is defined as a way of designating and assigning the responsibilities and division of work among the employees of an organization. Internal check can be defined in a limited way as it covers many aspects of an organization.

In internal check, a system is such constructed that the work of a subordinate gets automatically checked by the supervising authority. The checking proves if the work is being done as per the policies and guidelines of the company or not. He monitors the financial mechanism of the organization which enables him in ensuring that the records regarding operating data are being kept by the employee in accordance with accounting norms or not. Certain examples of auditing procedure are reviewing of documents, interviewing officials and checking the irregularities.

The main objective of audit procedures is to demonstrate the highly effective approaches for conduction of superior audits of commercial and non-public entities.

It provides a way for discussions to be done more practically and considering the management of audit engagements on a routinely basis. Audit procedure facilitates in minimization of technical language used for official statements to an easily readable and understandable advices and procedures. The audit procedure is designed for enhancement in quality of an auditor's practice. Through audit procedure an auditor gets a proper approach for performing audit engagements in a more effective and efficient manner.

In internal audit process, the following steps are adopted:

### ***Risk Based Audit Plan***

The first phase in the internal audit process is risk based audit plan. The Audit Committee of the Board of Governors approves this plan. It is updated on annual basis. When the plan is approved, it becomes a guideline for performing audits in the



upcoming year. Apart from the audits conducted under this plan, special audits and consulting works are also conducted in internal audit, on demand.

### ***Planning Phase***

In this phase, the audit staff evaluate the past audit work, go through the literature on the area under evaluation, and create an introductory review about the unit budgeted, actual revenues and expenses. The auditors determine the scope and objectives of audit so that they can use them as the base of the fieldwork phase. In the planning phase, an introductory meeting is conducted for discussing the objectives, timelines, and other important information related to audit so as to make the internal audit process easy. In this meeting, the audit staff may request for some information like organization chart, contact list and literature describing the organization's procedures, if available.

### ***Fieldwork Phase***

Fieldwork phase is the lengthiest phase of the internal audit process. In this phase, the following activities are performed:

- The audit staff collects information related to the auditee's operations
- The audit staff understands the organization's functions
- The audit staff determines the strengths and weaknesses of the organization. It includes analysis of financial, administrative and other business activities, functions and procedures.
- The audit staff takes interviews of the key personnel of the organization, observes business procedures, and reviews the audit process periodically with the organization's heads and personnel.
- Finally, this phase allows the audit staff to determine the areas of risk and concern in the internal controls and procedures of the organization. The staff discusses about these risks to the auditee before or on the conclusion of the fieldwork.

### ***Reporting Phase***

In reporting phase, all the work and activities performed in the fieldwork phase are compiled along with their results and then they are offered and discoursed with the client. The client should make action plans with timeframes and these plans should address all the recommendations made by the audit staff in their report. The final summary report is offered to the Senior Management and the Audit Committee for the purpose of reviewing.

### ***Follow-up Phase***

Depending on the timeframes mentioned in the action plans, a follow-up is conducted for making sure that the recommended measures are implemented.

#### **Check Your Progress**

Fill in the blanks:

1. The management can establish a separate department called \_\_\_\_\_ to keep a check on the effective operation of internal controls.
2. \_\_\_\_\_ function is to prevent errors and irregularities from occurring.
3. Duties are divided among people in order to minimise the \_\_\_\_\_.

*Contd.*

4. The approval and authorization from the supervisory body infers the \_\_\_\_\_ of the activity or transactions carried out by an employee.
5. The purpose of \_\_\_\_\_ is to find errors and frauds that have already taken place.
6. It is important that the employees of an organization possess \_\_\_\_\_ of the duties and responsibilities assigned to them.
7. An auditor can acknowledge the existence of an \_\_\_\_\_.
8. Internal check is defined as a way of \_\_\_\_\_ the responsibilities and division of work among the employees of an organization.
9. In internal check a system is such constructed that the work of a subordinate gets automatically checked by the \_\_\_\_\_.
10. The \_\_\_\_\_ in the internal audit process is risk based audit plan.
11. In \_\_\_\_\_, the audit staff evaluate the past audit work, go through the literature on the area under evaluation, create an introductory review about the unit budgeted, actual revenues and expenses.
12. \_\_\_\_\_ is the lengthiest phase of the internal audit process.
13. In \_\_\_\_\_, all the work and activities performed in the fieldwork phase are compiled along with their results and then they are presented and discussed with the client.
14. Depending on the timeframes mentioned in the action plans, a \_\_\_\_\_ is conducted for making sure that the recommended measures are implemented.

#### 4.8 LET US SUM UP

- Internal control can be defined as a whole system of controls including financial and other aspects, created by the management of an organization so that the business of the organization can function in proper order.
- Control environment is an integral part of internal control system; hence it is important to understand the meaning and factors affecting control environment.
- Planning and maintenance of internal control system is the responsibility of management.
- The management can establish a separate department called "Internal Audit" to keep a check on the effective operation of internal controls.
- In internal control, there are two types: preventive and detective controls.
- The purpose of preventive controls is the discouragement of errors and irregularities. Its function is to prevent errors and irregularities from occurring.
- The purpose of detective control is to find errors and frauds that have already taken place.
- An organization must have a well-developed plan. The responsibilities must be designated properly at different levels based on operational hierarchy.
- A record must be kept regarding the maintenance of control over assets liabilities, revenues and expenses. A scientifically developed system of record procedures must be considered.

- A managerial supervision is mandatory. Moreover, the organization's financial operations and positions must be revised and reviewed on a routine basis.
- In the system of internal control, the main concern of an auditor lies in the evaluation of the internal control system established in an organization.
- The auditor may be able to know the scope of reliability on reports, records and the certificates of the management.
- The implementation of internal check, unlike internal control, can be done at all levels of an organization, for instance, tactical level or operational level.
- Audit procedure can be defined as the techniques, tactics and steps undertaken by the auditor in order to assess, review and identify the inefficiencies in the company's operation.
- The main objective of audit procedures is to demonstrate the highly effective approaches for conduction of superior audits of commercial and non-public entities.
- In reporting phase, all the work and activities performed in the fieldwork phase are compiled along with their results and then they are presented and discussed with the client.
- Depending on the timeframes mentioned in the action plans, a follow-up is conducted for making sure that the recommended measures are implemented.

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#### 4.9 LESSON END ACTIVITY

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Prepare a report about the extent to which the auditor is responsible for system of internal control.

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#### 4.10 KEYWORDS

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**Internal Control:** A whole system of controls including financial and other aspects, created by the management of an organization so that the business of the organization can function in proper order

**Control Environment:** The overall attitude, awareness and actions of the management with regards to internal control system and its importance in the organization.

**Preventive Controls:** A control system which is used to prevent errors and irregularities from occurring. They help in ensuring the fulfilment of departmental objectives.

**Security of Asset:** A type of control, a restriction is made for accessing an equipment, inventories, and securities.

**Reviews of Performance:** A process of reviewing, certain informations are compared by the management. These informations can range from current performance of the company to budgets, forecasts and other benchmarks.

**Internal Check:** Internal check is a way of designating and assigning the responsibilities and division of work among the employees of an organization. Internal check can be defined in a limited way as it covers many aspects of an organization.

**Audit Procedure:** The techniques, tactics and steps undertaken by the auditor in order to assess, review and identify the inefficiencies in the company's operation.

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## 4.11 QUESTIONS FOR DISCUSSION

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1. What is internal control?
2. Discuss the types of internal control in detail.
3. List out the characteristics of a good internal control system.
4. What is the role of auditor in internal control system?
5. Differentiate between internal control and internal check
6. Describe the internal audit procedure.

### Check Your Progress: Model Answer

1. Internal Audit
2. Preventive controls
3. Risk or error and misappropriation
4. Verification and validation
5. Detective control
6. Good character and an in-depth understanding
7. Effective internal auditing
8. Designating and assigning
9. Supervising authority
10. First phase
11. Planning phase
12. Fieldwork phase
13. Reporting phase
14. Follow-up

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## 4.12 SUGGESTED READINGS

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A. Kumar, R. Sharma, *Auditing: Theory and Practice*, Atlantic Publishers and Distributors, New Delhi.

S. K. Basu, *Auditing: Principles and Techniques*, Pearson, New Delhi.

Ravinder Kumar, Virender Sharma, *Auditing: Principles and Practice*, PHI Learning, New Delhi.

## **BLOCK – III**

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## LESSON

# 5

### AN INTRODUCTION TO VOUCHING

#### CONTENTS

- 5.0 Aims and Objectives
- 5.1 Introduction
- 5.2 Meaning and Concept of Vouching
- 5.3 Aims of Vouching
- 5.4 Importance of Vouching
- 5.5 Difference between Vouching and Verification
- 5.6 Distinction between Vouching and Routine Checking
- 5.7 Concept of Vouchers
- 5.8 Internal and External Evidences
- 5.9 General Principles of Vouching
- 5.10 Teeming and Lading
- 5.11 Vouching of Different Types of Transactions
  - 5.11.1 Vouching of Capital Expenditure
  - 5.11.2 Vouching of Investments
  - 5.11.3 Vouching of Borrowing from Banks
  - 5.11.4 Vouching of Trading Transactions
  - 5.11.5 Vouching of Cash Book
- 5.12 Let Us Sum Up
- 5.13 Lesson End Activity
- 5.14 Keywords
- 5.15 Questions for Discussion
- 5.16 Suggested Readings

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#### 5.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Explain meaning and concept of vouching
- Discuss objectives and importance of vouching
- Differentiate between vouching and routine checking
- Describe the general principles of vouching and concept of voucher

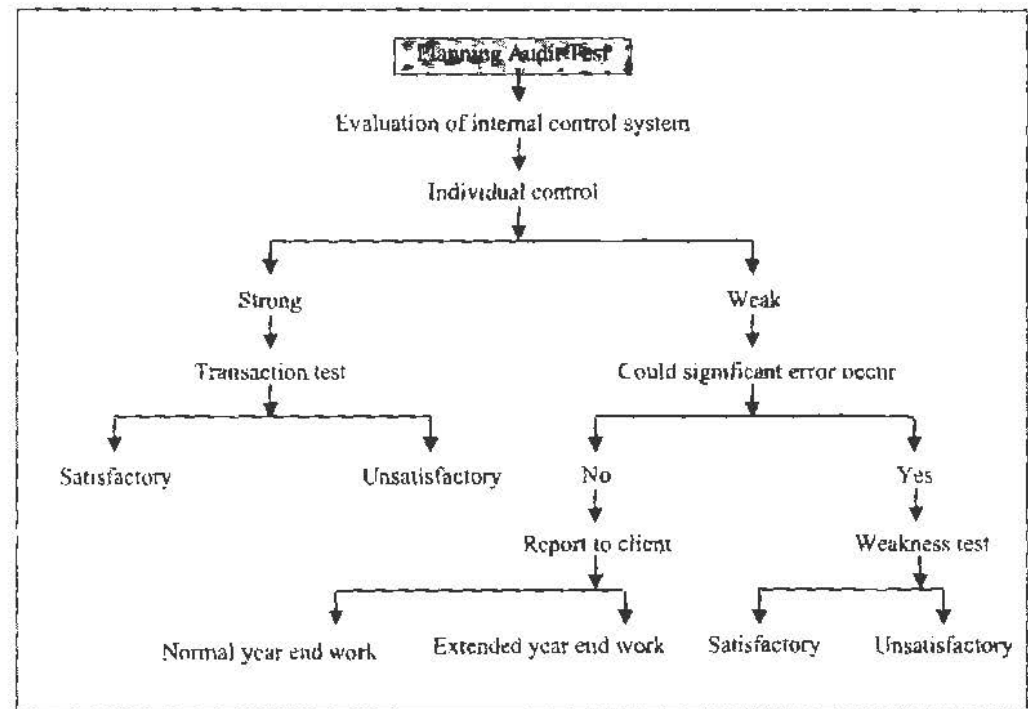


## 5.1 INTRODUCTION

After judging and recording the system of internal control, one is able to acknowledge the weak and strong points of the organization's system of internal control. In the next step, he will be able to make a plan regarding nature and limits of the audit tests he needs to perform. These audit tests are executed regarding accounting transactions of the organisation. In the concept of audit system, the most fundamental aspect is to create such an audit programme through which the demands of various accounting as well as control systems can be fulfilled.

The differentiation between transaction tests must be created. The tests are to be applied on strong aspect of internal controls. There may be some necessary deficiency in the internal controls, which may have an effect on the opinion and judgment of the auditor regarding accounts. In this circumstance weakness tests are applied.

The following 'planning audit test' diagram may be taken into consideration for the circumstances discussed above.



Source: <https://www.safaribooksonline.com/library/view/auditing-principles-and/9789332501447/ch05/chapter005.xhtml>

Figure 5.1: Transaction Tests

The vouching approach is crucial in every audit, but it must be adopted after taking into account a careful consideration of its results. In the process of audit testing the auditor must be careful even after performing extensive vouching because there must be possibility of his inability to conclude any assurance regarding the accuracy of records concerning other transactions that are not vouched.

Thus, in order to understand vouching it was necessary to discuss about the transaction tests, as vouching mainly concerns with the transactions of a business or organisation. Let us discuss vouching in detail in following sections.

## 5.2 MEANING AND CONCEPT OF VOUCHING

Vouching can be defined as the examination of such documents which provide evidence to support the authenticity and truthfulness of transactions which are

recorded in the books of account. Vouching is a technique meant to be followed by the auditor while performing an audit in order to certify that the records of transactions in the primary books of accounts are authentic and true.

Vouching basically consists of:

- Verification of transactions record, enclosed in the books of accounts along with documents should be relevant to act as an evidence.
- The considered authority is responsible for the entries that were made in the accounts.
- Examination should be undertaken in order to confirm the mentioned amount in the voucher has been dispatched to a correct account. It enables to discover the nature of transaction which would disclose the nature of the transaction on its insertion in the final statements of account.

Let us consider some important definitions of vouching.

“Vouching is the examination of the evidence offered in substantiation of entries in the books, including in such examination the proof so far as possible that no entries have been omitted from the books”.

*-Taylor and Perry*

“Vouching is a device used to prove that various transactions for the period are fairly, truly and sincerely reflected in the books of accounts”.

*-Joseph Lancaster*

Therefore, we can conclude that vouching is a technique of auditing. It enables to check the accuracy of the entries contained in the books of accounts. The checking is performed on the basis of documents available for evidences.

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### 5.3 AIMS OF VOUCHING

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A successful audit can occur if the vouching conducted by the auditor is efficient. If the vouching is conducted in an efficient manner, the results will be authentic and auditor is able to judge his opinions accordingly, hence conducting a proper audit is a necessity.

There are certain aims and objectives because of which vouching technique is considered by the auditor. These aims are as follows:

- Checking if the records of transactions contained in the book of accounts are accurate or not as per the evidences record in concerned documents or not.
- To carry out the verification about occurrences of fraud or error during the recording of transactions.
- To keep an eye on the proper authorization of each and every transaction recorded. Every transaction must be authorized by a responsible person.
- Ensuring the existence of a proper distinction between capital and revenue items during recording of the transactions.
- Having a proper precision while reporting truthfulness and fairness of the financial information.
- Ensuring if the figures provided in books of accounts are reliable or not.
- Confirming that transactions which do not relate with the entity under audit, are not entered in the books of accounts.
- Ensuring that the totalling, carrying forward and recording of the accounts are accurate and true.

## 5.4 IMPORTANCE OF VOUCHING

The first step of auditing is vouching. Before commencement of his work, an auditor has to go through an examination regarding entries in the accounts books. Here, vouching plays a crucial role by providing him a scope of correctness of books of accounts. The correctness and authenticity of account records is tested by vouching. On carrying out the vouching intelligently and carefully the audit work becomes hassle-free and easier for the auditor.

Vouching helps in locating the frauds and errors. Quoting the words of De Paula, "Vouching is the essence of auditing." Vouching is the base for success and failure of auditing.

Importance of vouching can be noted by following points:

1. Vouching is a reliable examination through which the entries in original books of accounts can be verified for ensuring the genuineness of the transactions. The genuineness of transactions depends on their authentication and compliance with the principles of accounting. The entries for recording account must be original otherwise the final account does not show the truth and fairness about profit and loss and other state of affairs in an organization. Thus vouching tests act as a basis for process of accounting.
2. Vouching enables an auditor to examine original evidences. He checks the entries through examination of evidences in order to authenticate them. Vouchers play a role by acting as a link between transactions and entries. Particulars such as dates, amounts, the names of parties, etc., are found out by vouching a transaction. Therefore, the correctness of details is established by comparing the entries in the book of accounts with the final evidences.
3. Vouching helps in detecting errors and frauds at the initial stage of auditing. The errors and frauds can be easily acknowledged by checking entries with original evidences. It initiates in assuming the irregularities and hence the preventive measures can be taken earlier for stopping any further immoral activity.
4. Vouching helps the auditor to be more alert regarding frauds and errors and he gets to a position for taking suitable measures of prevention saving the organization from loss. Thus he needs to perform vouching carefully because if he loses out an important aspect he may be held liable for the cause.

## 5.5 DIFFERENCE BETWEEN VOUCHING AND VERIFICATION

Table 5.1: Difference between Vouching and Verification

Vouching	Verification
Vouching is defined as validation of every entry in the books of account by considering vouchers such as receipts, invoices, correspondence, contracts etc.	Verification is defined as the examination regarding the existence of assets as per in the balance sheet in the name of the company and their proper values irrespective of any charges.
In vouching the auditor acknowledges what should be in existence.	In verification, the auditor can acknowledge the actual existence, hindrance-free and appropriate valuation of assets.
The concern of vouching lies with all items of income statement and the balance sheet items enduring change during the year.	On the other hand, the concern of verification lies with all the items of balance sheet.

Contd...

It is performed out with the help of vouchers.	Along with vouching, verification is performed by checking the physical existence, valuation and ownership of the assets.
Vouching can be carried out any time during the year.	Verification can be carried out after completion of accounts and drawing out of balances.
Commencement of vouching for an asset is done only once during the life time of the asset.	Assets are verified and their verification is shown in the balance sheet every year.
There is no inclusion valuation of assets and liabilities in vouching.	In verification the valuation of assets and liabilities is included.
Vouching is the first step taken before performing verification.	Verification is the next step after completion of vouching.

## 5.6 DISTINCTION BETWEEN VOUCHING AND ROUTINE CHECKING

Sometimes the concepts of vouching and routine checking are misunderstood to be the same. In broader terms, routine checking is a part of vouching. The scope and objective of routine checking is limited to the books of accounts only. On the other hand, vouching involves checking of all totals, sub-totals, carry forwards, posting and checking of all ledger accounts.

## 5.7 CONCEPT OF VOUCHERS

Vouching can't be carried out without vouchers. Vouchers are the internal and external documentary evidences which are used for supporting the entries made in the books of accounts of an organization.

To avail the documentary evidences, it is mandatory that every transaction has to be recorded in the books of accounts. The documentary evidences can be anything such as a receipt, counterfoil of a receipt, resolution passed in a meeting, cash memo, pay-in-slips, purchase invoices, minutes of a meeting etc. Such types of documentary evidences are called vouchers.

There are two types of vouchers, i.e., primary and collateral vouchers.

Primary Vouchers	Collateral Vouchers
Primary vouchers are those, which consist of written evidence that is available in original. For instance, purchase invoices, counterfoil of cash receipt etc.	Collateral vouchers are those which are unavailable in original, but their copies are available to act as evidence. These copies can be used for the purpose of audit. These copied evidences are known as collateral evidences. For instance, Copies of resolution passed at a meeting, Xerox copy of demand drafts etc.

Vouchers can be of two types on the basis of sources of documents, i.e., internal vouchers and external vouchers.

Internal Vouchers	External Vouchers
Vouchers which originate within the organisation are called as internal vouchers. For instance- sales invoices, minutes book of board meetings, material requisition slip etc.	Vouchers which originate from the outside sources are called as external vouchers. For instance, mortgage deed, bank statement etc.

## 5.8 INTERNAL AND EXTERNAL EVIDENCES

There are two types of evidences that can be obtained from a voucher, i.e., internal evidence and external evidence.

Internal Evidence	External Evidence
Internal evidences are such documents which are created and used within the client's organisation and never used outdoors of the organisation. For instance- duplicate sales invoices, employee's time reports, purchase requisitions, minute books etc. These documents are prepared in the normal course of organisation and they are a part of records of the concern.	External evidences are the ones which originate from outdoors of the client's organisation. For instance- payee's receipt, lease agreement, bank statement etc. At times, in some transactions the external evidence is acquired by the auditors directly such as a confirmation of balances from debtors and creditors.

For an auditor, external evidences are more reliable than internal evidence. Both types of evidences, either internal or external must be exposed to suitable examination. A validation should be attained for these evidences. A lack of validation will make the auditor to make a further investigation in order to arrive at the fact.

## 5.9 GENERAL PRINCIPLES OF VOUCHING

The auditor needs to follow certain principles while performing vouching in order to get appropriate and effective results.

- During the vouching of a transaction the auditor must provide a verification and authenticity of the transaction. He must check if the amount that has been recorded is accurate and the accounts are classified properly or not.
- The voucher which has been checked already by the auditor must be marked with a sign in order to avoid its use for fictitious transactions.
- Auditor must note that the concerned authority or the officer has authorised the voucher or not.
- In case, any voucher is found altered, the concerned officer's initials must be there to support it.
- The auditor must note if there is a proper distinction made between capital and revenue items or not.
- He must note the date of the voucher is correct or not as per the accounting period of that voucher.
- Auditor must ensure that the voucher is created in the client's name.
- Auditor must check that all the relevant documents which would have been expected to be received or created while the transactions have been entered.
- The nature of the receipt or payment which is dispatched to its concerned place, on its insertion in the final accounts, can be disclosed by checking alteration in amount of the voucher in the transaction.
- Every voucher must be dated and numbered serially.
- In the receipt, the amount must be mentioned in words and figures both. If any difference is found, then the auditor must investigate.
- In case any voucher is missing, the proper explanation must be asked for it by the concerned official. In case, the explanation turns out to unsatisfactory the investigation must be carried out further.

## 5.10 TEEMING AND LADING

Vouching is challenged by teeming and lading. These are the methods carried out to misappropriate cash. Misappropriation of cash is done by making false entries which are related to a transaction, which results in cancelling of further entries until such



fraud is discovered. This sort of method is also called as “delayed accounting of money received” as this method conceals the shortage through delaying the recording of cash receipts.

To deal with these challenges, the auditor should take the following steps as a part of vouching technique:

1. Verification of the debtors’ ledger, mainly those debtors who are paying their dues in part payments.
2. Collection of the balance confirmation certificate from debtors, whose accounts are shown as due.
3. Evaluation of the efficiency of the internal check system with regards to the receipts of cash from the customers of the organisation.
4. Auditor must have an acknowledgement of the discount facility provided to the customers and the amount of bad debts to be written off.
5. In case of suspicion of a fraud that has already been committed, auditor must perform a verification of those transactions which are shown in the cash book as deposited into bank and check reconciliation statement of the bank.
6. Sending the statement of accounts to the customers, whose accounts have been shown as due, mentioning a request in case if any discrepancy in the statement of account, the auditor must be contacted by the customer as soon as possible.

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## 5.11 VOUCHING OF DIFFERENT TYPES OF TRANSACTIONS

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There are various types of transactions in various organisations. Thus, vouching also differs as per the different aspects of different organizations. There are following types of vouching on the basis of organization and its aspects:

1. Vouching of capital expenditure
  - a. Land and building
  - b. Assets acquired on H.P. system
  - c. Trademark and copyright
2. Vouching of Investments
3. Vouching of borrowing from banks
4. Vouching of Trading Transactions
  - a. Credit purchases
  - b. Credit sales
  - c. Consignment sale
  - d. Goods on sale or return
5. Vouching of cash book
  - a. Collection from debtors
  - b. Interest and dividend received on investments

Some of these types of various transactions have been discussed in tables given on next page. There is a wide range of areas where vouching is performed as per the requirements of the transaction. The auditor has to deal with every transaction in every field differently. Thus vouching performed for one particular organization or its transactions cannot be applied on the other.



### 5.11.1 Vouching of Capital Expenditure

Capital expenditure is the expenditure which relates to purchase of fixed assets. For vouching these types of transactions, the authenticity of the transaction, should be checked.

Land and Building	
Documents to be Checked	Duty of the Auditor
<ul style="list-style-type: none"> <li>Title deed</li> <li>Mortgage deed in case of mortgaged property</li> <li>Broker's note</li> <li>Contract</li> <li>Receipts</li> <li>Architect's certificate</li> <li>Fixed asset register</li> <li>Minutes of the directors meeting</li> </ul>	<ul style="list-style-type: none"> <li>In case the land or building is freehold, auditor must verify it with the owner's title. In case of leasehold, the auditor must examine base deed.</li> <li>The checking of contract in case, the property is purchased directly from the vendor.</li> <li>Examination of ownership title of the property in favour of the client.</li> <li>Verification of incidental charges e.g., registration expenses of the property along with proper documents and receipts. Examination of capitalisation of these expenses.</li> <li>Examination of contract of the construction of a building for business purpose.</li> <li>Confirmation of the cost of construct and architect's certificate.</li> </ul>

### 5.11.2 Vouching of Investments

An example for vouching of investments is as follows:

Documents to be Checked	Duty of the Auditor
<ol style="list-style-type: none"> <li>Broker's purchase note</li> <li>Letter of allotment and calls</li> <li>Share certificate or debenture certificate</li> <li>Bank passbook</li> <li>Receipts</li> <li>Director's meeting minute book</li> </ol>	<ol style="list-style-type: none"> <li>Examination of investment as per accordance with the governing laws. Acknowledgements about the governing provisions of the Companies Act regarding investment are followed or not.</li> <li>In case the investment is purchased by a broker, auditor must verify the price paid as per the broker's bill and receipt.</li> <li>In case the investment is purchased through banks auditor must check bank passbook.</li> <li>The auditor must confirm the approval of the board for the purchase of investments, on the basis of the Directors' meeting minute book.</li> <li>He must perform a verification about the title of the investment by considering the register for confirm that the investments purchased have been transferred in the name of the company.</li> </ol>

### 5.11.3 Vouching of Borrowing from Banks

An example of vouching of borrowing from banks is given as follows:

Documents to be Checked	Duty of the Auditor
<ol style="list-style-type: none"> <li>Certificate from bank for securities deposited</li> <li>Minutes of the Board meeting</li> <li>Bank statement</li> <li>Letter of loan sanction</li> <li>Bank passbook</li> </ol>	<ol style="list-style-type: none"> <li>The auditor should confirm about the type of the loan (overdraft limits or cash credits) from the letter of loan sanctioned from the bank.</li> <li>Confirmation about the last-mentioned balance. The confirmation can be done by gaining a certificate from the bank that displays the balance in the accounts as it was at the end of the year.</li> </ol>

Contd ..

	<p>3. Obtain confirmation about the certificate taken from the bank which demonstrates the particulars related to securities deposited in the bank as a security for the loan. He must further confirm that the same has been disclosed appropriately and registered properly with the Registrar of Companies. And a record has been maintained in the register of charges</p> <p>4. Verifying the authority which is concerned for raising the loan.</p> <p>5. Confirming any disobeying of restrictions enclosed in Section 223 of the Companies Act concerning the determined amount of loan that the company can raise.</p>
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#### 5.11.4 Vouching of Trading Transactions

Credit Purchases	
Documents to be Checked	Duty of the Auditor
<ol style="list-style-type: none"> <li>1. Purchase invoices</li> <li>2. Copies of orders placed</li> <li>3. Goods received note</li> <li>4. Copies of challans from supplier</li> <li>5. Goods inward register</li> <li>6. Stock records</li> </ol>	<ol style="list-style-type: none"> <li>1. Auditor must confirm that the purchase book is properly maintained by entering all purchase invoices in it. Moreover, he must check that goods have actually been received by the client as per the goods entered in purchase books.</li> <li>2. He must carry out an examination of the internal check system of the company and note that the purchase book contains a record of only credit purchases of goods.</li> <li>3. He must confirm a responsible person has sanctioned the purchase of goods which are under the organizations dealing.</li> <li>4. He must check that goods purchased have been actually received by the client or not. He can consider the goods inward register, stock records and challan from the supplier. These documents must be authorised.</li> <li>5. He must seriously and carefully consider the purchases carried out in the first month and last month of accounting.</li> </ol>

#### 5.11.5 Vouching of Cash Book

Collection from Debtors	
Documents to be Checked	Duty of the Auditor
<ol style="list-style-type: none"> <li>1. Sales invoices</li> <li>2. Receipts issued to customers</li> <li>3. Statement of customer's accounts</li> <li>4. Existing and past discount chart</li> <li>5. Correspondence with the customers</li> </ol>	<p>The auditor should first check cash memo is issued to the customer; a counterfoil or carbon copy of such cash memo which is kept by the receiving clerk. The auditor must verify the received amount from customers on the basis of counterfoils or carbon copies issued</p> <p>The auditor must check if the amount received from customers has been entered in the cash book on the day of receiving or not.</p> <p>He must ensure if the receipts are numbered serially or not. In case any receipt is missing, the concerned officials must be asked for explanation</p> <p>If the auditor is suspicious he is free to contact the customers directly with the approval of the client in order to verify the receipt of cash from them</p>

Interest and Dividend Received on Investments	
Documents to be Checked	Duty of the Auditor
<ol style="list-style-type: none"> <li>1. Bank statement</li> <li>2. Dividend warrants</li> <li>3. Schedule of securities</li> <li>4. Agreement with party</li> </ol>	<ol style="list-style-type: none"> <li>1. During the vouching of dividends, the auditor must carry out a checking regarding dividend warrant counterfoils and covering letters which are received along with the cheques.</li> <li>2. In case the collection of dividend and interest is done from bank, the auditor must perform a verification of the amount from the bank statement. If the warrant is received and the amount is not collected, the auditor has to ensure that it has been shown as cheque yet to be collected</li> <li>3. In case of vouching interest, the auditor must ensure checking the fixed interest bearing security statement. The bank passbook must be checked in order to check interest on bank deposit. In case the interest is on the loan given to a party, the auditor can check the agreement between the company and concerned party.</li> <li>4. The auditor must ensure that all interest which is received and collected is accounted in the books and shown properly in the balance sheet.</li> </ol>

### Check Your Progress

#### Check Your Progress

Fill in the blanks:

1. In the concept of audit system, the most fundamental aspect is to create such an audit programme through which the demands of various \_\_\_\_\_ can be fulfilled.
2. Vouching can be defined as the examination of such documents which provide evidence to support the \_\_\_\_\_ of transactions which are recorded in the books of account.
3. One of the aims of vouching is ensuring the existence of a proper distinction between \_\_\_\_\_ items during recording of the transactions.
4. Vouching helps in locating the \_\_\_\_\_.
5. Verification can be carried out after \_\_\_\_\_ and drawing out of balances.
6. Routine checking is a part of \_\_\_\_\_.
7. \_\_\_\_\_ are called vouchers.
8. There are two types of vouchers, i.e., \_\_\_\_\_ and \_\_\_\_\_ vouchers.
9. Vouching is challenged by the \_\_\_\_\_.

## 5.12 LET US SUM UP

- Accounting is an extension of bookkeeping. Where bookkeeping ends, accounting begins. Bookkeeping records the business transactions in account books, accounting aims at recording, classifying and summarizing the business transactions in a useful manner.

- Accounting is a base and with its help, various returns, documents, statements, etc., are prepared.
- The main objective of accounting is to maintain a complete and systematic record of business transactions.
- Accounting provides useful and meaningful information to those who have interests in the business.
- A proper accounting system is essential to any business whether big or small in order to manage its daily functions and keeps the business running successfully
- Accounting information helps users to make better financial decisions. Users of financial information may be both internal and external to the organization.
- Accounting Information System (AIS) is a system in which the decision makers consider the data related to finance and accounts that has been collected, stored and processed. Generally, this system is computer-based and instigates to keep a track of activities related to accounts with the help of resources obtained from information technology.
- The matching concept suggests that the revenue earned in an accounting year is matched with the expenses incurred during the same period to generate that revenue.
- Human Resource Accounting means the accounting for human being as now in an organization human being is treated as an asset like other physical assets.
- Double entry system is a system wherein every transaction is being recorded in two different ledgers account.
- All accounts of the enterprise are broadly classified into two categories, viz., Personal accounts and Impersonal accounts. Impersonal accounts are further classified into two categories, viz., Real accounts and Nominal accounts.

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### 5.13 LESSON END ACTIVITY

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When financial accounts records all transactions related to a business then why there are different branches of accounts? Prepare a report stating the importance of branches of accounting and give a presentation on it.

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### 5.14 KEYWORDS

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**Vouchers:** The documentary evidences such as a receipt, counterfoil of a receipt, resolution passed in a meeting, cash memo, pay-in-slips, purchase invoices, minutes of a meeting etc.

**Internal evidence:** Internal evidences are such documents which are created and used within the client's organisation and never used outdoors of the organization.

**External evidences:** External evidences are the ones which originate from outdoors of the client's organisation. For instance, payee's receipt, lease agreement, bank statement etc.

**Teeming and lading:** Misappropriation of cash done by making false entries which are related to a transaction, which results in cancelling of further entries until such fraud is discovered

**Capital expenditure:** Capital expenditure is the expenditure which relates to purchase of fixed assets. For vouching these types of transactions, the authenticity of the transaction, should be checked.

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### 5.15 QUESTIONS FOR DISCUSSION

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1. Define accounting. What is the need of accounting?
2. Explain the meaning and concept of vouching.
3. What are the aims and objectives of vouching?
4. Explain the importance of vouching.
5. Differentiate between vouching and verification.
6. What are the differences between primary and collateral vouching?
7. Distinguish between internal and external evidences.
8. List the general principles of vouching.
9. Explain teeming and lading and provide the steps that can be taken to avoid them.
10. Describe vouching in different types of transactions.

#### **Check Your Progress: Model Answer**

1. Accounting as well as control systems
2. Authenticity and truthfulness
3. Capital and revenue
4. Frauds and errors
5. Completion of accounts
6. Vouching
7. Documentary evidences
8. Primary; collateral
9. Teeming and lading

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### 5.16 SUGGESTED READINGS

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A. Kumar, R. Sharma, *Auditing: Theory and Practice*, Atlantic Publishers and Distributors, New Delhi.

S. K. Basu, *Auditing: Principles and Techniques*, Pearson, New Delhi.

Ravinder Kumar, Virender Sharma, *Auditing: Principles and Practice*, PHI Learning, New Delhi.

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## LESSON

# 6

## VERIFICATION AND VALUATION

### CONTENTS

- 6.0 Aims and Objectives
- 6.1 Introduction
- 6.2 Meaning of Verification of Assets
  - 6.2.1 Importance of Verification of Assets
  - 6.2.2 Problems in Verification
- 6.3 Meaning of Valuation of Assets
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- 6.7 Verification of Investments
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- 6.11 Let Us Sum Up
- 6.12 Lesson End Activity
- 6.13 Keywords
- 6.14 Questions for Discussion
- 6.15 Suggested Readings

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### 6.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Explain the meaning of verification of assets
- Discuss the importance of valuation of assets



- Distinguish between verification and valuation
- Explain the general principles for verification and valuation of assets
- Discuss the verification and valuation of assets
- Elaborate the verification of investments
- Explain the verification of liabilities
- Discuss the events occurring after balance sheet date
- Explain the window dressing – a challenge to verification

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## 6.1 INTRODUCTION

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Among other duties of an auditor, the most important one is to verify the liabilities and assets as per the balance sheet. He is supposed to not only analyse the arithmetical accuracy of the transactions in the books of accounts but also check the record of assets in the balance sheet as per their actual existence. In case he fails in verification of assets he can be held liable for the damage on the client's part. Thus it is important to understand the meaning, importance and processes of verification as well as valuation of assets.

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## 6.2 MEANING OF VERIFICATION OF ASSETS

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Verification can be defined as the proof that confirms the existence of assets and liabilities as per the date mentioned in the balance sheet. Verification generally points towards the verification of assets of any concern, which can be performed through examining the value, ownership, existence and possession of any asset.

"Verification of assets implies an enquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets".

*-Spicer and Pegler*

Therefore, we can conclude that verification is a process, in which following aspects are included:

- Valuation of assets according to its proper value
- Ownership and title of the assets
- Confirming the existence of the assets
- Satisfaction of the situation that they are free from any charge or mortgage.

### 6.2.1 Importance of Verification of Assets

The importance of verification of assets is as follows:

- Verification proves the existence of asset.
- It confirms the value of asset as per the balance sheet.
- After vouching, the verification of assets sets the originality of existing asset and confirms that its entry is done properly on the same date when it was purchased.
- In case the balance sheet is found to be incorrect regarding the asset's value or it mentions any asset that does not exist, then it will lead to incorrect profit and loss account. Thus, in order to prevent such loss, auditor must carry out the verification of assets.

- Auditors' duty under the Companies Act has been extended by the promulgation of the Other Companies (Auditors Report) Order, 2003, issued under Section 227(4A) of the Companies Act.

### 6.2.2 Problems in Verification

Since, in the absence of proper verification of assets and liabilities the auditor faces the problem while certifying the balance sheet. The balance sheet is the only reliable source for him to acknowledge the true and fair view about the state of affairs of business. It is impossible on the part of the auditor to carry out verification under his responsibility and according to his own knowledge and expertise.

For example, suppose an auditor needs to carry out a verification of stock-in-trade when the accounting period ends. It will take a huge amount of time for him to complete a process. Moreover, an expert will be needed for helping him. There are some assets that do not exist physically, such as goodwill, patent, copyright, trademarks etc., hence in these situations the only basis of verification is the limited documents which are available.

"It is no part of an auditor's duty to take stock. No one contends that it is. He must rely on others for the details of stock-in-trade".

*- As per Kingston Cotton Mills Ltd. Case (1896)*

Hence on the auditor's part, no breach of duty can be applied. Since he cannot take stock himself and in case suspicious circumstances are not caught, he is free to accept a stock certificate. The stock certificate must be approved by a trusted official of the company.

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## 6.3 MEANING OF VALUATION OF ASSETS

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Valuation of assets means to examine the valuation of assets in order to check their accuracy and propriety. The assets are examined on the basis of the balance sheet of any concern at the end of the financial year.

Therefore, we can consider valuation as an operation, in which following aspects are included:

- To obtain each and every necessary information that is necessary regarding valuation.
- To analyse every figure which is available.
- To confirm the fact that the valuation is being carried out as per the conventions and accounting principles that is accepted generally.
- To ensure while valuation from year to year, the methods are being followed with consistency.
- To obtain an opinion about the accuracy of valuation.

### 6.3.1 Importance of Valuation of Assets

Primarily, the auditor has to verify the original cost of asset and make a confirmation, in every possible case, that the verified cost results in fair and reasonable valuation. To ascertain the original cost, certain well-defined ways of valuation are meant to be followed. Thus, valuation provides a true and fair cost of assets.

There are two basis on which the assets are valued:

1. **Going concern:** In this method, finding out and calculating the cost of acquisition of the concerned assets is important. Moreover, the rate of depreciation must be provided.
2. **Break-up value:** This method is considered during the wounding up of company. Through this method the assets are valued at their realisable value.

Therefore, there are different ways to determine the value of an asset. These ways can be adopted as per suitable to the auditor.

The auditor has to apply his knowledge and skill for assessing the value of each asset with a vision to approve its truth and fairness. He must regard the general principles for valuing the assets.

As per the view of 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 and to ascertain as far as possible that the current values are fair and reasonable and are in accordance with the accepted commercial principles".

Therefore, valuation acts as an important part of every audit. When the valuation of various assets and liabilities is done correctly, the balance sheet provides the correct and fair view. The auditor needs to check that the assets and liabilities that have appeared in the balance sheet do exhibit their proper value.

### 6.3.2 Problems in Valuation

There are various problems which can be faced by the auditor during conducting the valuation of assets and liabilities. These problems have been stated below:

1. **Character of the assets:** Sometimes it becomes impossible to identify what type of character does the asset shows for the purpose of valuation. It can either be a fixed asset or a current asset. The process of valuation for each of these types of assets differs from each other.
2. **Use of assets:** Sometimes a same asset is made available for sale and used again in the organization. In this case, the process of valuation depends on the nature of use of that asset, for example, stock of furniture.
3. **Estimated life:** In case of fixed assets, their life is uncertain. Hence the valuation is done on the basis of an estimated life of those assets. The lives of the fixed assets are not certain. The valuation of these assets is made on the basis of estimated life of the assets. Though, determining the estimate of asset's life is not easy.
4. **Eventual problems:** The auditor may face eventual problems as he is unable to consider the events which have taken place after the balance sheet date. This situation can have an impact on the valuation of assets.
5. **Lack of information:** The other problem faced by the auditor is that he cannot possess all the relevant information. These are such information which can be needed for taking into consideration by the auditor for determining the value of assets.

## 6.4 DIFFERENCE BETWEEN VERIFICATION AND VALUATION

	Verification	Valuation
<b>Meaning</b>	Verification is defined as the checking of the assets as per shown in the balance sheet. It must be in the name of business, if they exist or not, or is there any charge on it etc.	Valuation is defined as a process for determination of proper values of assets and liabilities as per mentioned in the balance sheet.
<b>Purpose</b>	To check and investigate about existence, ownership and possession of the assets.	To check and decide the appropriate values of assets according to principles which are generally accepted.
<b>Basis</b>	The type of assets and liabilities are the basis of verification.	There is no particular basis for valuation of an asset. The valuation depends upon the type of asset and liabilities.
<b>Certificate</b>	In case of verification, the auditor is unable to get an access of the certificates which verify the assets and liabilities.	In case of valuation, an auditor must mandatorily attain the certificates regarding the valuation of assets. The certificate is meant to be obtained from the officer who is responsible for the business unit.
<b>Vouching</b>	Vouching is included in verification.	It does not include vouching.

## 6.5 GENERAL PRINCIPLE OF VERIFICATION AND VALUATION OF ASSETS

The following are the general principles which are required to be considered by the auditor in conducting verification and valuation of assets in an organisation:

- The acquired asset's cost must be verified along with either its purchase agreement or with the ownership rights. Moreover, the receipts of the seller in respect of the price paid should also be verified.
- The expenditure on newly purchased assets should be verified. Moreover, in case of renewing or replacing the old assets, it should be made sure that their details have been recorded in a correct manner. The verification and recording must be done as per the method which has been followed generally.
- It is important to check the agreement of purchase and ascertaining the paid amount in case when the assets of a going concern are taken over by another concern.
- On the sale of an asset, the sale process must be vouched in order to refer the agreement in which the terms and conditions, counterfoils of receipt issued by the seller or any other available evidence are included.
- In case of selling a fixed asset through which a capital profit is earned, then this capital profit must be transferred to capital reserve. Though the limit of the profit is related only to the original cost, yet any profit or loss is bound to be recorded in the profit and loss account.
- It must be verified that the fixed assets actually exist either by physically inspecting or by making a comparison between the particulars of the assets and the asset register. It helps in confirming that particulars entered in the schedule which is attached to the balance sheet show the similar details in the asset register. Moreover, the total value must reconcile as per according to the general ledger balances.

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## 6.6 VERIFICATION AND VALUATION OF ASSETS

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Verification of asset is an essential audit technique. Usually, the scope of this technique is limited to:

- Inspection of assets
- Set of information about the property.

Through verification, the auditor must affirm the following:

- ❖ The resources are in existence on the date of the balance sheet.
- ❖ The concerned assets are obtained for use in the company.
- ❖ The resources have been brought under proper authority.
- ❖ The concern has got the right of ownership of the assets.
- ❖ The goods are free from any charge not revealed in the balance sheet.
- ❖ The resources are properly valued.
- ❖ The assets are correctly presented in the balance sheet.

Verification of assets is primarily the duty of the management. They're predicted to have a far greater understanding of the resources of the company as regards their state, place, etc., than what an outsider may have the ability to acquire in their review. They can ascertain the worth of their resources where they need to be contained in the balance sheet. The auditor is only anticipated to employ his skill and experience estimating the value of every strength with an opinion to affirm that they're honestly and fairly disclosed in the balance sheet. To apply verification methods, we can divide the resources into the following four classes:

1. Goodwill, patent, trademark, copyright, etc..
2. Fixed assets, viz. land and building, plant & machinery, accessories and furniture, motor vehicles, etc.
3. Present-day assets viz. stock-in-trade, sundry debtors, prepaid expenses and accrued incomes, cash, and bank balances etc.
4. Fictitious assets viz. preliminary expenses, discount on issue of shares or debentures, etc.

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## 6.7 VERIFICATION OF INVESTMENTS

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In executing an audit of investments, the auditor should aim at amassing adequate audit evidence to guarantee himself in regards to the existence, ownership, evaluation, and property of investment in favour of the customer.

The following aspects are important in this respect:

- **Existence:** The auditor should confirm that investments are shown on the balance sheet exist on the date of the balance sheet.
- **Assets:** The auditor should assure himself that investments shown in the balance sheet are all possessed by the venture.
- **Accounting documents:** He must assess the trades of acquisitions, disposal, etc., of their investments throughout the accounting period to be able to confirm as to if they are appropriately listed in the books of account.
- **Valuation:** He must affirm that investments are stated at the balance sheet in appropriate level based on the recognized accounting principles.

- **Disclosure:** He must also affirm that investments are correctly categorized and disclosed in the financial statements in line with the recognized accounting fundamentals and applicable statutory requirements.
- **Internal management:** The auditor must assess the internal control processes regarding investments to be able to ascertain the nature, timing, and extent of the procedural aspects. Virtually all of the business and business undertakings have investments of different kinds. In the event of investment and finance companies, the quantity of investment represents a significant portion of the overall assets of this concern. For verification and evaluation of investments, it may be broadly categorized into quoted and unquoted investments.

### 6.7.1 Quoted Investments Verification

The auditor must physically inspect the investments. It needs to be physically confirmed on the previous date of the accounting year. If the investments aren't in the ownership of this thing, a certificate ought to be obtained in the party involved.

The auditor needs to assure himself that the name of these investments is in the title of the customer itself.

The sale and purchase of investments must be confirmed about the agent's contract note, invoices of cost, etc.

In the event the quantity of sale or purchases of investments are large, the auditor should assess the cost about stock market quotes. The auditor must also inspect the applicable provisions of Section 227(1 A) and also see that a provider not having an investment or banking firm, whether so much of their assets of the company as represented by stocks and debentures are sold at a cost less than that where they had been bought by the business. He must also affirm that the applicable conditions of this CARO, 2003 are duly complied with in this respect.

The auditor needs to satisfy himself that a proper value of investments is correct and the financial statements disclose the same, accordingly to the recognized accounting policies and practices and applicable statutory requirements. He must examine if in calculating the price of investments, the cost incurred due to transport charges, stamp duty, etc., is included in the expense of investment. The auditor may determine that the market values of investments are in agreement with the real marketplace reports or stock market quotes. To judge the general reasonableness of the total spent, the auditor may associate the amount together with all the preceding year's amount and compute appropriate ratios.

### 6.7.2 Unquoted Investments Verification

The auditor should determine the ability of this enterprise to create investments by analyzing the memorandum of association in the event of investment with a business, to make sure that the investments aren't ultra-vires the provider. He must also determine that all of the legal obligations concerning the purchase of investments are duly complied with. Where investments are in massive amounts, the auditor should get the program of securities licensed by a senior officer of the business. The announcement should contain the name of the investment, the book value, the market cost, date of purchase, etc.

The auditor must check all of the investment at once. Investments are obviously a hierarchical character as well as their affirmation at precisely the same time eliminates the threat of their substitution for others.

The unquoted stocks held as investments must be valued at cost. But if on account of the most recent annual accounts of these companies, the stocks of which are kept as



investment along with the dividend documents of these businesses, it looks like there has happened a permanent and substantial decrease in the value of investments, more appropriate supply against such collapse in values ought to be made. The auditor should affirm that compliance. Unquoted shares and debentures must be revealed at the balance sheet below the original head "Investments" on the asset side, indicating the manner of evaluation and the aggregate quantity of their unquoted shares and debentures must also be mentioned.

The auditor should affirm that fairness and preference shares are displayed individually as well entirely paid up and partly paid shares being distinguished. In the event the shares or debentures are stored at the subsidiary of the business, the auditor must guarantee that those above ought to be shown beneath the sub-heading "Investment in subsidiaries."

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## 6.8 VERIFICATION OF LIABILITIES

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The verification of liabilities is of equal significance because of an advantage. The auditor must satisfy himself that, requirements whether contingent or existing have been correctly determined and disclosed in the balance sheet. If obligations are overstated or understated, the balance sheet won't represent a reasonable view of the state of affairs of the business. Hence, the auditor must ensure the following:

- That obligations shown in the balance sheet are now payable.
- That all obligations are accurately recorded in the novels recorded.
- Obligations must be paid because of the logical operations of the organization, and the nature and extent of contingent liabilities were revealed in the balance sheet using a footnote.

To apply affirmation technique, we can divide the obligations into the following three classes:

- Fixed or long-term obligations, viz., share funds, debentures, the long-term loan from the bank and other financial institutions, etc.
- Present-day obligations
- Contingent obligations viz., contested liability of earnings tax suits pending for compensation etc.

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## 6.9 EVENTS OCCURRING AFTER BALANCE SHEET DATE

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The Accounting Standard-4 on 'Contingencies and events occurring after the balance sheet date' is about the treatment of emergencies and events which take place after the balance sheet date in financial statements. In accordance with the announcement, events occurring after the balance sheet date are such important events that can be both favourable and unfavourable, and take place between the balance sheet date and the date on which the Board of Directors accepts the financial statements in the case of a business and the event of another thing from the corresponding approving authority. A number of these developments may necessitate alterations to assets and liabilities as per the balance sheet date or it may need a disclosure. These include the following:

### 6.9.1 Adjusting Events

Adjusting events are such significant events which take place after the balance sheet date which offer added advice materially affecting the conclusion of the numbers regarding conditions existing at the balance sheet date.

### *Example*

An adjustment could be made for bad debt, and this can be supported by the bankruptcy of the client, which happens following the balance sheet date.

### **6.9.2 Non-adjusting Events**

Non-adjusting events are those events that have no relation to prevailing conditions at the balance sheet date. But, the disclosure of these facts is usually made if these signify different changes affecting the presence of the business in the balance sheet date.

### *Example*

The destruction of the main region of the mill building with fire after the balance sheet date won't need any alteration in the balance sheet because no circumstances occur on the time of the balance sheet.

### **6.9.3 Other Events**

There's another category that happens after the balance sheet date must be reflected in the financial statements due to statutory requirements or due to their distinctive nature

### *Example*

The dividend proposed or declared after the balance sheet date in respect of the time the financial statements covered.

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## **6.10 WINDOW DRESSING – A CHALLENGE TO VERIFICATION**

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Window dressing might be defined to reveal the ratio position favourable. The position is shown that it appears to be much better than that which it is when the window is embraced in statement demonstrations. It's more of a misrepresentation compared to fraud. Window dressing can be practiced at almost any one of the following manners:

- Deferring purchases, i.e., buy a year can be revealed as of next year making extensive drive to your collection of book debts to demonstrate the book equilibrium favourable recording incomes to the next year.
- Ahead of Time in the balances of the present year showing borrowed capital as long-term debt capital making provision for insufficient amount of depreciation and bad debts charging revenue expenditure as capital cost making over-and/or undervaluation of assets and liabilities inflating the proceeds by inputting none existent items of purchase yields and earnings return.
- Implementing secret reservations throughout the depression period without making the truth known to the shareholders.

He must observe that no efforts are made by the customer to embrace window dressing. It might occasionally happen that the client may demonstrate a definite advantage in the newspaper only that, in reality, doesn't exist physically. Window dressing is an obstacle to this job of affirmation that ought to be confronted from the auditor through running of successful verification function.

### Check Your Progress

Fill in the blanks:

1. When the valuation of various assets and liabilities is done correctly, the \_\_\_\_\_ provides the correct and fair view.
2. Vouching is included in \_\_\_\_\_.
3. The auditor is not able to get \_\_\_\_\_ of verification of assets and liabilities.
4. \_\_\_\_\_ events are those events that do not relate to conditions existing at the balance sheet date.

## 6.11 LET US SUM UP

- Verification can be defined as the proof that confirms the existence of assets and liabilities as per the date mentioned in the balance sheet.
- After vouching, the verification of assets sets the originality of existing asset and confirms that its entry is done properly on the same date when it was purchased.
- Since, in the absence of proper verification of assets and liabilities the auditor faces the problem while certifying the balance sheet. The balance sheet is the only reliable source for him to acknowledge the true and fair view about the state of affairs of business.
- Valuation of assets means, to examine the valuation of assets in order to check their accuracy and propriety.
- Primarily, the auditor has to verify the original cost of asset and make a confirmation, in every possible case that the verified cost results in fair and reasonable valuation.
- There are various problems which can be faced by the auditor during conducting the valuation of assets and liabilities. Some of them are character, use, estimated life of assets.
- The acquired asset's cost must be verified along with either its purchase agreement or with the ownership rights. Moreover, the receipts of the seller in respect of the price paid should also be verified.
- Verification of assets is primarily the duty of the management. They're predicted to have a far greater understanding of the resources of the company as regards their state, place, etc., than what an outsider may have the ability to acquire in their review.
- In executing an audit of investments, the auditor should aim at amassing adequate audit evidence to guarantee himself in regards to the existence, ownership, evaluation, and property of investment in favour of the customer.
- The verification of liabilities is of equal significance because of an advantage. The auditor must satisfy himself that, requirements whether contingent or existing have been correctly determined and disclosed in the balance sheet.
- Window dressing might be defined to reveal the ratio position favourable. The position is shown that it appears to be much better than that which it is when the window is embraced in statement demonstrations. It's more of a misrepresentation compared to fraud.

## 6.12 LESSON END ACTIVITY

Select any two companies of different sector of your choice and study the verification of assets in these companies. Identify the difference in their verification. Prepare a report on the same and give a presentation on it.

## 6.13 KEYWORDS

**Verification:** It can be defined as the proof that confirms the existence of assets and liabilities as per the date mentioned in the balance sheet.

**Valuation of assets:** It means, to examine the valuation of assets in order to check their accuracy and propriety.

**Adjusting events:** They are such significant events which take place after the balance sheet date which offers added advice materially affecting the conclusion of the numbers regarding conditions existing at the balance sheet date.

**Window dressing:** It's more of a misrepresentation compared to fraud.

## 6.14 QUESTIONS FOR DISCUSSION

1. Discuss the meaning of verification of assets.
2. Why valuation of assets is important?
3. Differentiate between verification and valuation.
4. List the general principles for verification and valuation of assets.
5. How verification and valuation of assets is performed?
6. Discuss the verification of investments.
7. Explain the verification of liabilities.
8. What are the events that occur after balance sheet date?

### Check Your Progress: Model Answer

1. Balance sheet
2. Verification
3. Certificate
4. Non-adjusting

## 6.15 SUGGESTED READINGS

A. Kumar, R. Sharma, *Auditing: Theory and Practice*, Atlantic Publishers and Distributors, New Delhi.

S. K. Basu, *Auditing: Principles and Techniques*, Pearson, New Delhi.

Ravinder Kumar, Virender Sharma, *Auditing: Principles and Practice*, PHI Learning, New Delhi.

## **BLOCK – IV**

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# LESSON

## 7

### AN INTRODUCTION TO COMPANY AUDIT

#### CONTENTS

- 7.0 Aims and Objectives
- 7.1 Introduction
- 7.2 Company Audit
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- 7.13 Auditor's Report
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*Contd.*



- 7.14 Let Us Sum Up
- 7.15 Lesson End Activity
- 7.16 Keywords
- 7.17 Questions for Discussion
- 7.18 Suggested Readings

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## 7.0 AIMS AND OBJECTIVES

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After studying this lesson, you should be able to:

- Explain accounting and its needs
- Discuss the concepts of accounting
- Explain the accounting conventions
- Describe the concept of double entry system

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## 7.1 INTRODUCTION

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In India, it is mandatory for every company must be registered and have a practicing chartered accountant for auditing their accounts. As per the Section 224 (1) of the Companies Act, 1956, it is mentioned that every private or public company must keep an auditor for audit of their accounts.

This type of audit is known as statutory audit. Through statutory audit, it is ensured by Companies Act, that the individuals carrying on business with others money are liable and accountable to them.

As per the Companies Act, 1956 it is required for every business to have compulsory audit of every Joint Stock Company. To perform such responsible task an auditor is to be appointed. He is responsible for submitting his report to the shareholders of the Company. There are certain preliminaries through which an auditor must go through after his appointment and before he carries out auditing.

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## 7.2 COMPANY AUDIT

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A company can be defined as an artificial body that creates a separation between entity and the owner or the management. A financial statement of the company must be submitted at the end of a certain period. This statement must go through an examination performed properly by the auditor. The auditor submits the statement to give his opinion and advice. Thus, to give true and fair view of his opinion, he needs to apply certain proper auditing techniques for the examination and such types of techniques and activities are called company audit.

According to the section 183(3) of the company Act 1994: Company Audit is defined as, "The balance sheet and profit and loss account or income or expenditure account, cashflow statement of a company shall be caused to be audited by the auditor of the company as in the Companies act provided and the auditor's report shall be attached there to and the report shall be read before the company in General meeting".

The Preliminaries of company audit are as follows:

1. Check the appointment if an auditor is as per the order and legal.

In order to ensure that legal appointment of an auditor following aspects must be considered:

- (a) The organisation where he was appointed as first auditor and a copy of the resolution by the directors about his appointment must be attained.
- (b) In case he was appointed in place of a retiring auditor, it must be enquired in writing from the retiring auditor. The circumstances under which the previous auditor retired must be checked. Moreover, the concern of the previous auditor must be considered. The retiring auditor's objections to the new auditor's appointment must be considered, if there were any objections, the failure on part of auditor must be treated as a breach of professional etiquette.
- (c) In case he is appointed by the shareholders in an annual general meeting, he must acquire a copy of shareholders' resolution for his appointment. The auditor to be appointed must inform the registrar within a period of 30 days regarding his acceptance or unacceptance of the appointment.
- (d) The appointed auditor must acquire a copy of director's resolution, in case his appointment is done in a casual vacancy.

2. A certified list of books used in the company, which also acts as important documents must be obtained by the appointed auditor.

He must obtain the following:

- (a) **Memorandum of Association:** The auditor must thoroughly revise these documents, mainly the Objects Clause. Then he should check if any transaction does not ultra vires the Memorandum. If any ultra vires is found, he should acknowledge the shareholders. He must further check the issue of Share Capital. The share capital must be within the limits of authorised capital of company and as per the Companies Act. In case, the authorised capital exceeds he is needed to acquire a copy of resolution. Moreover, he must carefully examine Memorandum's provisions which are related to the company's accounts.
- (b) **Articles of Association:** The auditor must go through the document carefully in order to satisfy himself regarding the following aspects:
  - (i) The issue related to share capital and its sub-divisions
  - (ii) The payment regarding underwriting commission and brokerage on shares
  - (iii) The amount for minimum subscription, as per specified in the Articles
  - (iv) The call dates and the amount of the calls
  - (v) The rate of interest which must be charged on Calls-in-arrears and the rate of interest which must be paid on calls-in-advance
  - (vi) Rules which are regarded for Forfeiture and re-issue of forfeited shares
  - (vii) Borrowing powers of the company and the directors
  - (viii) Rules which regard about the reorganisation of the share capital
  - (ix) Rules which regard the appointment, remuneration, powers and duties of the auditor adding to the statutory powers and duties;

- (x) The appointment, remuneration, removal, rights and duties of the directors and various officers of the company
- (xi) Rules which regard to the meetings
- (xii) Power of voting for shareholders
- (xiii) Company's accounts and audit
- (xiv) Dividends and reserve.

The above-mentioned aspects act as important clauses that relate to certain matters specifically.

The above are a few important clauses relating to specific matters. In case any company does not own Articles of Association, then the application of Table A of the Companies Act must be taken into action. The auditor is liable for the Articles of association; hence he cannot plead about his unawareness of them. Therefore, he must note the changes made in the articles.

- (c) **Prospectus:** Prospectus acts as a crucial document. The auditor must carry out a careful examination of the prospectus and ascertain the fact that it includes the same points as stated in the Articles. In case of first company the auditor must examine all the contracts which are entered with the vendors. This examination helps him to find out the contracts, if there are any, with the third parties, underwriters as well as brokers. The prospectus states following information:

- ❖ Issue of shares at discount
- ❖ Payable amounts on applications
- ❖ Allotment
- ❖ Calls

The crucial examination of prospectus is also necessary in the subsequent audit procedure.

- (d) **List of Books:** He must ask for the submission of a list of all books of accounts as well as statistical and statutory books. The statistical and statutory books are maintained by the company and important books are kept by the registered office of the company. Hence the auditor must take an account of all the necessary documents and books.
- (e) **Contracts:** In case of purchasing of assets with the underwriters, brokers and promoters, there might be some contracts between company and the vendors. Thus, an auditor must take these contracts into his acknowledgement and go through them carefully. The auditor must confirm the statement given in the prospectus of the company and its relation to these contracts. He must check the correctness of statements and their correct record has been entered in the books of accounts.
- (f) **Minute Books:** As per mentioned under Section 193, Minute Books are statutory Books. There are three types of Minutes Books which are maintained by every company—
  - (i) Minute Book of the Shareholders' Meetings
  - (ii) Minute Book of the meetings of the Board of Directors
  - (iii) Minute Book of the various committees appointed by the Board of Directors.

They are kept in the form of bound books. The auditor must check if the minutes that have been recorded in the minute books are properly certified by the chairman in the meeting.

The minute books when audited help the auditor in vouching of various transactions. These transactions may include the following:

- ❖ Adoption of the annual accounts
- ❖ Calls on shares
- ❖ Director's fees and expenses
- ❖ Appointment of first auditor and his remuneration
- ❖ Authorization of capital expenditure etc.

(g) **Last Balance Sheet, Profit & Loss Accounts and Audit Reports:** These documents must be inspected by the auditor in order to get a confirmation about the correct record of balance in the new books. The inspection of last audit helps the auditor in gaining useful information for his subsequent work of audit. The recommendations of his preceding auditor must be checked in case they have been carried out properly or not. With the help of previous audit reports, the auditor will be able to understand the working of the company better. He must also consider the minute book of shareholders to gain necessary information about the adoption of accounts.

(h) **Certificate of Incorporation and Commencement of Business:** The auditor must examine the certificate of Incorporation so that the date of formation of company can be ascertained to him. Moreover, in case of public limited company, the auditor must carry out an examination of the certificate to commence business.

(i) **System of Internal Check:** A written statement from a responsible officer must be obtained by the auditor. The statement must be regarding the following systems adopted by the company:

- ❖ System of internal check
- ❖ Internal audit
- ❖ System of accountancy

A list of officers of the company and their assigned jobs must be taken into concern by the auditor. This helps the auditor for disposing any queries in less time. If the auditor finds any doubtful transactions he can directly contact to the concerned officer regarding any important information.

(j) **Audit Report:** According to the Section 227 (2) of the Companies Act, the auditor is bound to submit a report concerning audited accounts to the Shareholders of the company. He needs to prepare the report of accounts audited by him. Every balance sheet and profit and loss account along with audited report and other legal documents must be annexed to the balance sheet.

The report thus prepared is meant to be presented in the Annual General Meeting during the tenure period of the auditor. The report must be addressing to shareholders and then sent to the Secretary of the Company. The report must be duly signed by the secretary and after the approval of accounts by the Board and signed by the Directors, the auditor gets the authority to sign them. (Section 215)

Certain additional matters as per specified by the Central Government u/s 227 (4-A) of the Companies Act must be included in the report. The Central Government, under this provision holds the authority to direct the auditor regarding the examination of

specific problems which lies in the members' interests and thus the report too. Through auditor government can bring out information regarding shareholders which can suit best to their interest.

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## 7.4 QUALIFICATIONS OF AUDITOR

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We have already discussed the importance of an auditor in a company. Every company requires an auditor either, public or private. The accounts are meant to be annually audited by a professional auditor. The professional auditor must have certain qualifications. As per the Section 226 of the Companies Act, a qualified auditor has been defined as "a person shall not be qualified for appointment as auditor of a Company unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act 1949".

Any individual owning a certificate prescribed under the Restricted Auditors Certificate (Part B States) Rules, 1956 is meant to be act as a qualified auditor of a company.

The Central Government holds following powers regarding such certificates:

- Creating the rules for the grant
- Renewal of such certificates
- suspension of such certificates
- Cancellation of such certificates
- Prescription of conditions
- Restrictions of certificates

Despite of these powers, the Central Government must provide a notification to this effect in the official gazette, according to (Section 216(2) (b)).

The qualification of an auditor can be decided on the following points:

- a. Passing an examination conducted by Institute of Chartered Accountants of India
- b. After passing the examination he must have a membership of the Institute of the Chartered Accountants
- c. He must have a certificate of practice as per the rules of Restricted Auditors Certificate (Part B States) Rules, 1956

If he does not hold either of the above mentions qualifications, he cannot be qualified for acting as an auditor of a company.

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## 7.5 DISQUALIFICATIONS OF AUDITOR

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From the above discussion, it is can be made clear that the following cannot act as an auditor of a Company:

**[Section 226 (3)]. & (4)**

- (i) A corporate body
- (ii) An officer (a director, managing director, manager or secretary) or company's employee
- (iii) The company's partner
- (iv) Any individual owning the company more than ₹ 1,000

- (v) Any person who guarantees security of indebtedness of third person to the company to an amount more than ₹ 1,000.
- (vi) Any individual who disqualifies the appointment as an auditor of the company's subsidiary or holding company or a subsidiary of a holding company.
- (vi) Any such individual who holds any security after the date of commencement of companies (Amendment) Act, 2000 for a period of one year.

Therefore, the persons governed per the clauses of Sec. 226(3) are meant to be disqualified from appointment as an Auditor of a Company.

## 7.6 COMPANY AUDITOR: APPOINTMENT AND REMOVAL

A company auditor can be appointed and removed by the following:

- (i) A body corporate (because of its characteristic feature of limited liability); or
- (ii) An officer or employee of the company under audit
- (iii) Any partner of the company, or anyone who is employed as an officer
- (iv) A person who holds a liability to the company for amount more than one thousand rupees, or who has given any guarantee for amount more than one thousand rupees
- (v) A person who is responsible for the security, i.e. an instrument with whom the company's voting rights are carried with
- (vi) Under section 226 (4), a person who must be disqualified for appointment as an auditor of a company on above mentioned grounds, he cannot be eligible for appointment with any other body corporate which may be that company's subsidiary or that company's holding company or that company's fellow subsidiary.

## 7.7 APPOINTMENT OF AUDITORS - SECTION 224

As per section 224 of the act, there are provisions provided in detail with regards to appointing a statutory auditor. This section is applicable for all kinds of companies [except sub-sections 224 (A) and 224 (1B)].

The Act has consigned the power for appointing an auditor to the following persons:

- The directors
- The shareholders
- The Central Government and
- The Comptroller and Auditor General of India

### 7.7.1 Appointment by Directors

#### a. First Auditors

- i. The first auditor/auditors must be appointed by the board of directors within one month of the date of registration of the company by a valid resolution.
- ii. The appointed auditor must hold his position in the office until the first annual general meeting gets concluded.



**b. Casual Vacancy**

- i. The casual vacancy can be filled in the auditor's office by the director's power to do so. The exceptional circumstances are when the working auditor gives a prior resignation.
- ii. The auditor holding casual vacancy must hold his position in the office until the next annual general meeting has been concluded.

**7.7.2 Appointment by Shareholders**

- a. **First Auditors:** In case of director's failure in appointing the first auditor, then by passing a resolution at a general meeting, the shareholders will be held responsible for appointing an auditor(s).
- c. **Subsequent Auditors:** When of subsequent auditor is appointed the auditor must be informed by the company within the period of seven days of his appointment. Moreover, the auditor must inform the registrar in written about his acceptance or rejection of the appointment. He must inform within the seven days of receiving the receipt of information from the company. The subsequent auditors can be appointed by ordinary resolution and special resolution. These resolutions have been discussed below in detail.
  - (i) **By ordinary resolution:** According to the provisions of section 224 (1), subsequent auditors should be appointed at each annual general meeting by the shareholders. The appointment must be done by passing a resolution. The subsequent auditor holds his position in the office until the next annual general meeting has been concluded.
  - (ii) **By special resolution:** In some companies, the auditor is appointed once the company approves of it by carrying out a special resolution. Under Section 224A, in case of a company, which possess a subscribed share capital of more than twenty-five per cent, whether individually or in any combination, by:
    - (a) A public financial institution or a Government company or Central Government or any State Government.
    - (b) Any financial or other institution which was recognised by any provincial or State Act in which a State Government holds a subscribed capital of at least 51%.
    - (c) A nationalised bank or any general insurance company

**c. Casual Vacancy**

- i. If there is a casual vacancy in auditor's office that takes place because of resignation, then the company must fill the position only in the general meeting.
- ii. If the casual vacancy takes place because of any other reason and not resignation, then in this case the shareholders have the power to appoint an auditor on the director's failure to fill that vacancy.

**7.7.3 Appointment by the Central Government**

- (i) In case, at an annual general meeting the company fails to appoint an auditor, then the Central Government holds the power to appoint a person for filling the vacancy under powers conferred upon it by section 224(3). The terms, 'fails to appoint or re-appoint' also include the auditor's refusal for accepting the appointment.



- (ii) The company needs to get Government into notice of the above fact within the seven days of annual general meeting failing to which every officer of the company will be defaulted and punished with a fine extending up to five thousand rupees.
- (iii) The panel of names suggested by the applicant company are taken into consideration by the Central Government for the appointment of an auditor.
- (iv) It must be noted that, in case the appointment of an individual as an auditor is void *ab initio*, then it must be treated as a casual vacancy otherwise it would give a hike to the Central Government's powers as per the section 224 (3).

#### **7.7.4 Appointment by the Comptroller and Auditor General**

The appointments and re-appointments of auditors are done by Comptroller and Auditor General, in case of Government companies.

##### ***Compulsory re-appointment***

Generally, an auditor appointed by any kind of concerned authority, must be mandatorily re-appointed as per a resolution passed at the annual general meeting. Yet, the retiring auditor cannot be re-appointed in the following cases:

- (i) If he does not possess qualification for re-appointment
- (ii) If he has given a written notice to the company, regarding his un-willingness for being re-appointed.
- (iii) In case of already passing a resolution at the meeting
- (iv) In case a notice proposing to appoint some other person in the place of retiring auditor has been given.
- (v) In case of auditor's inability in complying with the ceiling on number of audits as per section 224(1B).

In case of re-appointment of an auditor who has retired, it is must to pass a resolution because automatic re-appointment is not permissible

#### **7.7.5 Ceilling on number of Audits**

In case a person is acting as an auditor for a specified number of companies, he cannot be appointed or re-appointed by the company or Board of directors. However, the 'specified number' does not includes audit of private companies

#### **7.7.6 Special Resolution and the appointment of an Auditor**

Under the Companies Amendment Act, 1974, as per its Section 224-A, it is required to pass a special resolution regarding appointment or re-appointment of an auditor(s) at every annual general meeting for the companies possessing an amount less than 25% of the subscribed capital either individually or in combination.

In case the company fails to pass a special resolution in the annual General Meeting, the right for appointment of an auditor to that company lies in the hands of the Central Government.

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## 7.8 REMOVAL OF AN AUDITOR - SECTION 224 (7) AND SECTION 225

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An auditor can be removed because of certain reasons and liabilities. As per section 224 (7) of the Act there are certain provisions which relates to removal of an auditor of a company before the expiry of term are provided. These provisions are:

- (a) **Removal of first auditor:** In the general meeting of the company (and not the board of directors), the first auditor whose appointment was done by the directors of the company before the expiry of the term; for removal of such first auditor, there is no need of former approval by Central Government.
- (b) **Removal of subsequent auditor:** The removal of subsequent auditor can take place before expiring of his term. The shareholders can remove only after getting a prior approval from the Central Government.

The prior approval is needed from shareholders and Central Government so that the situation of removal of an auditor by the directors of the company without any adequacy and justification of reasons can be avoided.

### 7.8.1 Removal after the Expiry of the Term

As per the procedures mentioned in section 225, an auditor can be removed after expiring of his term in the office. The following procedures must be considered as per this section in case of removing a retiring auditor and appointing another at his place:

1. **Special notice:** The shareholders holding ten per cent voting rights in the company must give a special notice mentioning about their intention to move such resolutions. They need to mention in the notice their wish to nominate some other person to be appointed as an auditor. The special notice must be given to the company at least 14 days prior to the annual general meeting.
2. **Notice to be sent to retiring auditor:** A copy of such notice must be sent to the retiring auditor as soon as the company receives the special notice.
3. **Right of retiring auditor to make a representation:** The retiring auditor can rightfully make a written representation with respect to the company. He can ask the company for a notification regarding the representatives of shareholders for appointment of a new auditor.
4. **Right to get representation circulated:** On receiving the representations, the company must make a notice of the meeting mentioning the fact of representations. A copy of such notice is meant to be sent to each member of the company who receives the notice of the meeting. In case of failure to do such, these representations must be read out during the next meeting.
5. **Ground for exemption:** In case the company or any aggrieved individual sends an application to the central government and the government is satisfied with fact that the auditors are securing needless publicity or defamatory publicity. Then, in such circumstance, the government can exempt the company from sending the copy of representations to the members or reading them out at the general meeting.
6. **Right to attend meeting:** The auditor who is being removed can rightfully attend the general meeting and speak on his behalf.
7. **Passing of resolution:** In General Meeting, an auditor can be removed by passing a resolution.

## 7.9 REMUNERATION OF AN AUDITOR

The remuneration of an auditor is decided and fixed by the authority who has appointed him. Thus, it is clear that where the auditor is appointed his remuneration must be fixed by the body who has appointed him. If he is appointed:

- By the Board, it must fix the remuneration
- By the Share Holders in the General Meeting, the remuneration must be fixed in the Annual General Meeting
- Appointed by the Central Government, the remuneration must be fixed by the Government itself.

The manner of fixing the remuneration can also be laid down in The General Meeting.

The auditor, who is getting retired, must get the remuneration, when he is reappointed in the General Meeting.

Extra-remuneration can be claimed by an auditor if he did some extra work. The remuneration paid in such case must be revealed in the Profit and Loss Account of the Company also as per Schedule VI Part II Clause B.

Any amount paid by the Company for the auditor(s) expenses must be included in his remuneration.

## 7.10 RIGHTS AND POWERS OF AN AUDITOR

The Companies Act provides certain rights and powers so that he can perform his duties as an auditor faithfully. These rights and powers are discussed as following:

1. **Right to inspect books of accounts (S, 227)(1):** As per section 227 (1), an auditor has the liberty to see and check the account books, statutory books, statistical books and costing books and the vouchers i.e., documentary evidence of any nature with the concern to books and accounts under Audit. He can rightfully access the books and vouchers of the branch. The basis of this right roots to the *Cuff vs. London and County Land Building Co. Ltd. (1912)* case.
2. **Right to ask for information and clarifications. (S. 227) (1):** The auditor has been provided with the right to attain any relevant information and explanation from the directors and officers of the company. These information and explanation are necessary for performing his duties as an auditor during auditing the books of account of the Company.
3. **Right to get notice of the general meeting and attend it. (S. 231):** As per Section 231, it is auditor's right to collect a notice regarding general meeting and be present during it. He can attend every meeting held by the investors or shareholders of the company.
4. **Right to make a statement in the meeting:** The auditor has the liberty and right for making a statement in the meeting held by shareholders. The auditor can rightfully make a statement only in the matter of accounts of the company in the shareholder's meeting. He is not bound to make a statement but in case the chairman of the meeting asks him to make any statements, he must only answer the questions about the accounts.
5. **Right to be indemnified. (Section 633):** Under Section 633 the auditor has been provided with right to assure or indemnify about the assets of the company for all legitimate expenditures attained by him for his defence in case any law suit has

been filed against him for any Civil or Criminal proceedings, on a condition that he has been innocent in these cases by the court.

6. **Right to visit the Branches:** The auditor can rightfully make a visit to each branch of the company, which is connected to the audit of these branches or of the Company. In case these branches do not have a separate auditor and moreover, they can't be provided any exemption by the Central Government for being audited. Thus, the auditor is free to visit the branches of the company provided the above-mentioned circumstances.
7. **Right to take legal and technical advice:** The auditor is provided with the right to take any legal, expert or technical advice which is connected to performance of his work. Despite of the expert's advice, he destined to give an opinion of his own in the audit report rather than expert's advice.
8. **Right to ask for remuneration:** The auditor can rightfully ask about his remuneration after the completion of company's audit work. In case he is dismissed after his appointment, he is authorised for his fees.
9. **Right to sign the audit report (S. 229):** As per Section 229, the audit report can be signed by the auditor.

In case of a firm acting as the auditor, a partner of such firm can sign the audit report only in the condition that he is a practising Chartered Accountant in India. In case any document of the company is needed to be authenticated as per the requirement of law, such partner or the auditor have a right to sign those documents for authentication.

10. **Right to correction of wrong statements:** In case of wrong statements created by the directors in the general meeting, the auditor is provided the right to correct such statements. The exceptional condition is that, the statement should only be in relation to the company's accounts audited by him.

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## 7.11 DUTIES OF AN AUDITOR

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Duties of an auditor can be stated under two heads:

- A. Duties under the Companies Act
- B. Duties as per the Legal Decisions

Let us see these duties under these heads separately.

### 7.11.1 Duties under the Companies Act

The auditor has to perform following duties as per the Companies Act:

1. To investigate and make special enquiries in relation with the matters related to loans, advances, transactions, loans, account books and relevant documents. (Sec. 227 (IA)).
2. To make report to the shareholders. He is bound to make a report for the company's members. The report must have an examination of accounts carried out by him. Moreover, the report must include an examination of every balance sheet, every profit and loss account which was laid before the company in the general meeting during his tenure of office. (Section 227 (2, 3 & 4)).

He has to prepare a report in the name of the members and not the directors, yet he was appointed by the directors. At the time, an auditor submits his report to the Secretary of the company, he is freed from his duties. He is not liable to

acknowledge whether the same report has been sent to the members of the company or not and either they received it properly or not.

The Audit Report must specifically include the following aspects besides other necessary things:

- (a) His opinion must be based on explanation of the best of his information. Following his explanations, the accounts must give the required information as per the Act.
  - (b) A view stating truth and fairness of the activities of the company must be explained in the balance sheet. For establishing truth and fairness of company's profit and loss in a financial year, the balance sheet must be matched with the profit and loss account prepared at the financial year's end.
  - (c) He must access every relevant information and explanations that he needs for performing his audit.
  - (d) As per his opinion, proper books of account as per law's requirement must be kept by the company. Moreover, the proper returns for the purposes of his audit must be received from the branches he has not visited.
  - (e) The company's balance-sheet and profit and loss account is meant to be dealt with the report in agreement with the books of account and returns.
3. ***Duty to state the reasons for the answers in negative:*** In case of any negative answers to any of the points stated above, the auditor is responsible for an explanation about the cause for the replies provided in his report.
  4. ***Duty to include in the report, the matters as directed by the Central government:*** Under Section 227 (4A) the Central Government empowered to require by order, that a statement on such matters must be included in the auditor's report. Central Government must consult the Institute of Chartered Accountants of India before making any such order, regarding the classes of description or companies and other subsidiary matters projected to be justified therein.
  5. ***Duty to sign the audit report:*** As per Section 229, the auditor must dutifully sign the report audited by him before he sends it to the company's secretary.
  6. ***Duty to give a report upon the Prospectus (Section 56 (1)):*** The auditor bound to provide his report upon the Prospectus that is issued by an existing company. He must also provide his report about all the relevant assets, liabilities and Profit and Loss of such a company.
  7. ***Duty to certify the Statutory Report (Section 165 (4)):*** The auditor must certify the correctness of the Statutory Report regarding the following:
    - (a) The allotted number of shares by the company whether for cash or any other consideration instead of cash
    - (b) The total amount of cash the company has received in respect of all the shares allotted, distinguished as aforesaid
    - (c) Make an abstract of the receipt of the company and the payments
  8. ***Duty to declare the solvency of the Directors, (Section 488 (2) (b)):*** In case of Voluntary Liquidation of the company, it is auditor's responsibility to announce the solvency of the directors.
  9. ***Duty to provide a report related to the Profit and Loss Account and the Balance Sheet in which the Declaration of Solvency is attached, (Section 488 (2) (b)):*** In case there is a Voluntary Liquidation of the Company that has taken place, then

the auditor is responsible for providing his report mentioning Profit and Loss Account and the Balance Sheet in which the declaration of solvency is attached. The declaration of solvency is made on company's director's behalf.

10. **Duty to assist the Investigators (Section 240 (v) (b)):** The auditor is bound to assist the investigators in whichever way he can, in case any affair related to the company needs an investigation. If investigators ask for the working papers related to audit, the auditor must present all the necessary papers in this regard.
11. **Duty to assist the Advocate General:** The auditor must help the Advocate General in an enquiry made by Advocate General against the directors.

### 7.11.2 Duties according to the Legal Decisions

Some matters are taken to the law court and the courts decide to fix some duties for the auditors. These duties are as follows:

1. In case of contravention of the provisions of the Company Law, it is auditor's duty to inform the members and shareholders of the company.
2. An auditor must have an enrolment with the Institute of Chartered Accountants of India and get a certificate obtained from the same to practice auditing.
3. He must have an acquaintance with company law provisions and carry out an enquiry about it from his preceding auditor in written.
4. He is not permitted to appeal or campaign for his appointment as the auditor of the company. Moreover, he is restricted to make an approach to any member of the company.
5. It is his duty to make an enquiry for the truthfulness and fairness in state of affairs of the company. After the enquiry, he needs to submit a proper report regarding the same.
6. He is dutifully bound to verify cash in hand himself and do not neglect his work.
7. It is auditor's duty to check the Debenture Trust Deed and get verification, if the debentures issued by the company follow the terms laid down in the trust Deed.
8. Duty to verify the investments himself.
9. Duty to perform his task with ability, care and skill.
10. Duty to verify the inventories and the ledger accounts.
11. Duty to inspect all securities in person and check that they are in the safe custody of the Secretary of the Company.

The auditors have been penalised for not performing the duties mentioned above by courts. Thus, the auditors must take these duties into careful consideration.

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## 7.12 LIABILITIES OF AN AUDITOR

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There is a difference in the liabilities of an auditor of a company and the liabilities of an auditor appointed by a firm.

The duties of a company auditor have been defined as per the Companies Act. His liabilities arise because of these duties. The liabilities have been divided under the following headings:

- a. Civil Liability
- b. Criminal Liability



- c. Liability towards third parties
- d. Liability for libel

In the cases mentioned above, the liability for one or more causes lies with the auditor as mentioned below:

- i. Liability for Negligence under the law of Agency
- ii. Liability for Misfeasance under the Statutes—Companies Act and Indian Penal Code

Let us now discuss these liabilities in some detail.

### 7.12.1 Civil Liability

#### *i. Liability for Negligence:*

- Under the law of Agency, an auditor can be held liable for negligence and must pay for the damages to the affected party or parties.
- In case of a company's suffering a loss because of the auditor's actions, he must make good for this loss.
- In case the company doesn't suffer from any loss, the auditor can't be held liable for negligence.
- In case the company suffers loss without his negligence, he is not responsible for such a loss.

If the party/parties want the auditor to hold responsible for his negligence, the following aspects, be proved:

- (a) That he was negligent
- (b) The company has suffered the loss because of his negligence
- (c) The person whom the auditor owes a duty has suffered the loss. He cannot be comforted of his liability by an agreement created between him and his client.

'Negligence' includes the following acts:

- i. Not checking the Articles of Association and not objecting the payment of dividends out of capital
- ii. Not getting the statements of accounts from the creditors and not finding out the errors and frauds
- iii. Not verifying the Cash and Petty Cash
- iv. Not reporting the client about the insufficiency in provision for bad and doubtful debts, which can result in inflation of the profits for dividends, therefore paying dividends out of capital.

#### *Liabilities for Misfeasance*

- The term 'misfeasance' means a breach of trust or duty.
- When the auditor performs his duties in negligence and it makes the company to suffer from a loss on this account, the auditor can be held as liable for Misfeasance and he must cover the company for such loss.
- Under Section 543 of the Companies Act, the auditor is also liable for damages. On application of liquidator of the company, the auditor can be put under charges by the court for misfeasance and order him to compensate the loss.

- Though, under Section 633 of the Companies Act, the auditor has a right appealing to the court. He can be excused by the court partly or fully if the court is satisfied that his actions were honest and reasonable.
- Hence, the auditor is not meant to be granted any relief in case of Criminal liability but only in case of Civil liability.

### 7.12.2 Criminal Liability

Criminal liability of the auditor arises under the following Acts:

1. Under the Indian Penal Code
2. Under the Companies Act
3. Under the Income-tax Act
4. Under the Life Insurance Corporation Act
5. Under the Banking Companies Act
6. Under the Chartered Accountants Act

#### 1. *Under the Indian Penal Code:*

- ❖ The auditor is meant to be liable as a criminal in case of issuing or signing any certificate that can be required by law as an evidence, yet he is acknowledged of the falsity in any material point in that certificate.
- ❖ He is meant to be punished in the same manner as if he provided any evidence carrying falsity. (Section 197).

#### 2. *Under the Companies Act:* He is criminally liable for the following acts:

- (a) To authorise the issue of a false prospectus. He can be punished by a penalty fine up to ₹ 50,000 or imprisonment up to a period of 2 years, or both. (S. 63)
- (b) To induce persons fraudulently for investing their money by purchasing shares or debentures of the company. Under section 68, the punishment is imprisonment for a term extending up to 5 years or a fine extending up to ₹ 1,00,000 or both.
- (c) To make a report containing matters related to any fraud required under section 227 i.e., in case the report does not follow the necessities of Section 227 or any of the company's document is signed or validated by him which does not obey the above section or the report or any other document is signed or validated by any person other than the auditor himself who is unauthorised to do so. As a punishment, a penalty of ₹ 10,000 in both the above cases is prescribed by the law.
- (d) *To forge the books.* In case the auditor has been proved guilty to destroy, damage, alter, falsify or conceal any books, documents or safeties or is aware of making of any falsified or fraud entries in any concerned register, book of account or document of the company's belonging, he can be held for punishment of imprisonment for seven years at least and be responsible to pay the considerable fines and penalties. (Section- 539).
- (e) In case of delinquency i.e., making a false statement disobediently, while the company winds up or he certifies an untrue return, report, balance-sheet or gives a falsified certification or he certifies an untrue document during the company's winding up. All such activities put him under the liability for criminal offences and the liquidator can straight away carry out his prosecution or refer the case to the Registrar. (Section 545).

- (f) If he interprets any falsified statements in the balance-sheet or any other relevant document or damages and alters any voucher, then the punishment can be imprisonment for at most two years along with the considerable fine to be paid by him.

Criminal offences include the following acts, for which he is punishable with fine or imprisonment or both—

- (a) Disobedient submission of a false report;
  - (b) Concealment of the fraudulent entries in the account books;
  - (c) Abolishing the vouchers and documents which are concerned to account books;
  - (d) Destroying the company's property;
  - (e) Assisting in the misrepresentation of the account;
  - (f) Disobedient certification of the false accounts;
  - (g) Creating a false statement, yet he is acknowledged of its falsity;
  - (h) Taking any bribe while he gets discharged from his duties as an auditor
3. Under the Income Tax Act (Section 278)
  4. Under the Life Insurance Corporation Act (Section 104)
  5. Under the Banking Companies Act (Section 46)
  6. Under criminal breach of trust (Section 46 A)
  7. If found guilty in Public Examination, a declaration for disqualification is made so that he can't be appointed as an auditor for 5 years. (Section 46 A)
  6. Under the Chartered Accountant Act, 1949 (section 122)

### 7.12.3 Liabilities towards Third Parties

Generally, an auditor is not liable to third party or parties. He is only liable to his employer. Yet, if the third parties can prove the following points he shall be liable towards therein too:

- a. The statement carries untrue facts
- b. The person making the statement was acknowledged of the statement's being untrue. Or he was ignorant consciously whether it was true or not
- c. That the statement was made intentionally so that the third party should act upon it
- d. That the third party did act on the faith of the statement in the prospectus

The controversy over auditor's liability to the third party is now settled and the auditor is now held liable because of the following reasons:

- (a) Certification of the improper accounting procedure because of which misappropriation of an employed client could not be detected
- (b) Negligence committed on behalf of an employee of the auditor
- (c) Commission of errors while preparing the final accounts

### **7.12.4 Liability for Libel**

In case the auditor has made any libellous or slanderous statement which is bonafide and does not carry any malice, then he cannot be held liable. He can be held liable only if he makes such statements outside the scope and limits of his duties.

#### ***Liability of an Honorary Auditor***

Whether the auditor is paid or honorary, he can be held liable for his actions and omissions. Even when there is no monetary consideration involved, the agreement with his client is valid as per the law.

#### ***Liability of a Joint Auditor***

There is no strong provision under Companies Act regarding the liabilities of the joint auditor, but the Institute of Chartered Accountants of India, has issued a statement about the liability of joint auditor. As per this statement, the whole work related to audit is meant to be divided between the auditors. Every auditor is responsible only for his own part of work. In the absence of the division of work all the joint auditors involved in the audit procedure will be responsible.

#### ***Liability of Local Auditors***

In case a company has various branches in the country and abroad, it appoints local auditors for every branch. In case the auditor at the Head Office clearly stated in his own audit report, that he relied wholly upon the statements and figures provided by the local auditors. Then, the auditor at the Head Office will be held liable for actions of local auditors.

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## **7.13 AUDITOR'S REPORT**

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- An auditor's report delivers an opinion about the financial statements of the company. His report confirms the validity and reliability of the statements.
- Finalisation of financial statements must contain auditor's report which is an evaluation. The report must be made by a licensed accountant or auditor. The report is essential for providing an overview of evaluation about the company's financial statement, which is meant to be valid and reliable.
- The aim of auditor's report is to provide a document rational declaration that a company's financial statements are errorless.

### **7.13.1 Preparation of the Report**

- The report after the audit of financial statements must have a scope of accountant or auditor's freedom for sharing their opinion and judgement about the extent of validity and reliability of the financial statements.
- The report must contain company's position and its financial statements in accuracy. The auditor must also mention if he connected with the company externally or internally.
- Auditor is free for sharing any reservations about the situation of the finances or relevant additional information of the company, in his report. Reservations may take place in case of auditor's disagreement with something found in the financial statements. For example: an auditor can disagree with the management's way of valuation of an asset as they believe that it will have more necessary impact on the financial statements.

### 7.13.2 In the Report

There are certain rules with concern to auditor's report. These rules list out the aspect to be included in his report and the way how items must be reported.

Auditor's report must be adhering to the standards as established by the governing bodies. Standards such as those set by the UK Generally Accepted Accounting Practice (UK GAAP) help in assuring the external users about fairness of financial statements as per the auditor's opinion and is based on a commonly accepted framework. A typical auditor's report will state:

1. The company that has been audited and accounting method adopted by it
2. The responsibility of the auditor and his report
3. Reservations (if any)
4. Conclusion
5. Any additional information\*
6. A management report\*
7. The date and auditor's signature

\*Note: Items 5 and 6 are omitted if there is no additional information and/or in case the management chooses not to prepare a management report. There is no requirement of management reports until it is listed in the financial statements. In such case, it must be ensured by the auditor that the management reports have consistency with rest of the financial documentation.

### 7.13.3 Four Types of Reports

The three types reports are discussed below:

1. **The clean or unqualified report:** This type of report specifies the opinion of auditor regarding the documents he was provided for evaluation. The evaluation carried out by auditor specifies the financial activities of the company and the correctness and acceptability of the records. This report also provides that the business has been following all the important practices and adheres to the conditions as per set by the UK GAAP. This is the best type of report a company can receive.
2. **The qualified report:** Generally, this type of report is considered as positive. This report specifies that nothing improper or wrong has been found in the final documentation by the auditor. Yet, the qualified indicated that the standards set by UK GAAP, have not been considered by the audited company. In this report, an extra section must be included. This section must address the reason for not being considered as an unqualified report or opinion of the auditor.
3. **The adverse report or opinion:** The adverse report means the company's non-adherence to standards set by the UK GAAP. Moreover, it specifies that the auditor has found discrepancies in the company's financial statements. There are two sorts of possibilities for such a conclusion:
  - a. Mistakes carried out in the auditing process
  - b. Any fraudulent activity within the company itself.

In case of adverse report, the company is required to revise their documentations before being audited again for the next time.

4. **Disclaimer of opinion:** It is a less common report. In simpler terms, it means that the auditor could complete the audit due to a particular reason.

### Check Your Progress

Fill in the blanks:

1. A company can be defined as an artificial body that creates a separation between \_\_\_\_\_ or the management.
2. A certified \_\_\_\_\_ used in the company, which also acts as important documents must be obtained by the appointed auditor.
3. As per Section 227 (2) of the Companies Act, the auditor is bound to submit a report concerning \_\_\_\_\_ to the Shareholders of the company.
4. An auditor must have a certificate of practice under the \_\_\_\_\_.
5. An auditor can be appointed or removed by a person who is a \_\_\_\_\_, or who is in the employment of \_\_\_\_\_ of the company.
6. The \_\_\_\_\_ must be appointed by the board of directors within one month of the date of registration of the company by a valid resolution.
7. In case of re-appointment of an auditor who has retired, it is must to pass a resolution because \_\_\_\_\_ is not permissible.
8. If an auditor is appointed by the Board, it must fix the auditor's \_\_\_\_\_.
9. Despite of the \_\_\_\_\_ an auditor bound to give his own opinion in the audit report instead of experts' advice.

## 7.14 LET US SUM UP

- Company Audit is defined as, "The balance sheet and profit and loss account or income or expenditure account, cashflow statement of a company shall be caused to be audited by the auditor of the company as in the Companies act provides and the auditor's report shall be attached there to and the report shall be read before the company in General meeting".
- Preliminaries of company audit include, Memorandum of Association, Articles of Association, Prospectus, List of Books, Minute Books, Last balance Sheet, Profit & Loss Accounts and Audit Reports, Certificate of Incorporation and Commencement of Business, System of Internal Check and Audit Report.
- As per the Section 226 of the Companies Act, a qualified auditor has been defined as, "a person shall not be qualified for appointment as auditor of a Company unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act 1949".
- Under section 226 (4), a person who must be disqualified for appointment as an auditor of a company on certain grounds, he must not possess the eligibility for being appointed with another corporate body which may be a subsidiary to the company.
- As per Section 224 of the Companies Act has consigned the power for appointing an auditor to the directors, the shareholders, the Central Government and the Comptroller and Auditor General of India.



- In case, at an annual general meeting the company fails to appoint an auditor, then the Central Government holds the power to appoint a person to fill up the vacant position under powers conferred upon it by Section 224(3).
- As per the section 224 (7) of the Act provisions relating to removal of an auditor of a company before the expiry of term are provided.
- The remuneration of an auditor is meant to be decided by the authority who appoints him.
- An auditor gets certain rights and powers from the Companies Act, so that he can perform his duties as an Auditor in a faithful manner.
- Duties of an auditor can be mentioned under two headings; Duties under the Companies Act and Duties as per the Legal Decisions.
- The liabilities of an auditor have been divided as Civil Liability, Criminal Liability, Liability towards third parties, Liability for libel.
- An auditor's report delivers an opinion about the financial statements of the company. His report confirms the validity and reliability of the statements.
- The report after the audit of financial statements must have a scope of accountant or auditor's freedom for sharing their opinion and judgement about the extent of validity and reliability of the financial statements.
- Auditor's report must be adhering to the standards as established by the bodies who govern. Standards which are set by the UK Generally Accepted Accounting Practice (UK GAAP) must be followed.
- There are four types of auditor's report, i.e., clean or unqualified report, qualified report, adverse report or opinion, disclaimer of opinion.

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## 7.15 LESSON END ACTIVITY

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Prepare a presentation about the procedure of preparing an audit report for a company XYZ Ltd.

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## 7.16 KEYWORDS

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**Company Audit:** The documents such as balance sheet, profit and loss account, income or expenditure account, cash-flow statement of a company are meant to be audited by a qualified auditor appointed by the company according to provisions provided by The Companies Act. And the auditor's report must be attached and read before the company in General meeting.

**Minute Books:** As mentioned under Section 193, Minute Books are statutory Books. The minute books when audited help the auditor in vouching of various transactions.

**Qualified Auditor:** Unless a person who can be called a Chartered Accountant as per the meaning of the Chartered Accountants Act, 1949, he remains unqualified for being appointed as auditor of a Company.

**Extra-remuneration:** Extra money to be paid for extra work done by the auditor.

**Body corporate:** Body corporate denotes a company incorporated in India, a foreign company, a public financial institution, a nationalised bank and a corporation formed under any special Indian or foreign law and as per the Companies act except as expressly excluded by the definition.

**Misfeasance:** A breach of trust or duty.

**Auditor's Report:** An auditor's report delivers an opinion about the financial statements of the company. His report confirms the validity and reliability of the statements.

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### 7.17 QUESTIONS FOR DISCUSSION

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1. What is company audit? Discuss in detail.
2. Describe the preliminaries of company audit.
3. What are the qualifications of an auditor?
4. What are the disqualifications of an auditor?
5. Discuss in detail about removal and appointment of an auditor.
6. How remuneration of an auditor is decided?
7. Describe the rights and powers of an auditor.
8. What are the duties of an auditor?
9. What are the liabilities of an auditor?
10. Discuss how the auditor's report is prepared and what is included in the report?
11. How many types of auditor's report are there? Discuss each of them in brief.

#### Check Your Progress: Model Answer

1. Entity and the owner
2. List of books
3. Audited accounts
4. Restricted Auditors Certificate (Part B States) Rules, 1956
5. Partner; an officer
6. First auditor/auditors
7. Automatic re-appointment
8. Remuneration
9. Experts' advice

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### 7.18 SUGGESTED READINGS

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A. Kumar, R. Sharma, *Auditing: Theory and Practice*, Atlantic Publishers and Distributors, New Delhi.

S. K. Basu, *Auditing: Principles and Techniques*, Pearson, New Delhi.

Ravinder Kumar, Virender Sharma, *Auditing: Principles and Practice*, PHI Learning, New Delhi.

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## LESSON

# 8

## DIVISIBLE PROFITS AND DIVIDENDS

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  - 8.2.1 Profit Vs Divisible Profit
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- 8.13 Let Us Sum Up
- 8.14 Lesson End Activity
- 8.15 Keywords
- 8.16 Questions for Discussion
- 8.17 Suggested Readings

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### 8.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Explain the concept of profit
- Discuss the divisible profit
- Discuss the principal determinants of divisible profit
- Explain the meaning of dividend
- Discuss the companies act relating to payment of dividend
- Discuss the companies act regarding unpaid and unclaimed dividend
- Explain the payment of dividend out of capital profit

- Discuss the payment of dividend out of capital
- Explain the general guidelines for distribution of dividend
- Explain the articles of association regarding dividend
- Discuss the auditor's duty as regards payment of dividend
- Explain the payment of interim dividend

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## 8.1 INTRODUCTION

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The main objective of any business organisation is profit, but the term 'profit' does not have any exact meaning in the accountant's language. Profit may be defined, "as the increase in the net value of assets of a business over their net value at the commencement of a given period which has arisen other than by capital adjustment".

According to the viewpoint expressed by the court in the case *Spanish Prospecting Co. Ltd. (1911)*, "the profit of an enterprise can be ascertained by computing the market value of its net assets at two accounting dates. The increase or decrease in the net worth is the profit or loss for the intervening period".

The Institute of Chartered Accountants of India has defined 'profit' in its Guidance Notes on Terms used in Financial Statements as, "the excess of revenue over related costs".

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## 8.2 DIVISIBLE PROFIT

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Divisible profit is defined as the share of profit earned by the company gets legally distributed to the stakeholder or shareholders of that company through the method of dividend.

There is no specific definition provided for the term 'divisible profit' in the Companies Act, neither it mentions the meaning of term 'profit'. Only Section 205 of the act lays down that "no dividend can be declared or paid by a company except out of current profits or past undistributed profits or both, arrived at after providing for depreciation or money provided by the government for payment of dividend in pursuance of a guarantee given by the government."

### 8.2.1 Profit Vs Divisible Profit

All the profits of a company cannot be said to be divisible. Only those portions of the profit, which can be legally distributed to the shareholders of the company in the form of dividends, are called as divisible profits. A number of factors are required to be considered for the determination of divisible profit. Out of different important factors, the following four considerations govern the determination of divisible profit to a great extent:

- Accounting principles
- Provisions of the Companies Act
- Provisions of the Memorandum and Articles of Association
- Legal judgments

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## 8.3 PRINCIPAL DETERMINANTS OF DIVISIBLE PROFIT

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Several matters influence the determination of divisible profits. These arise from the provisions of law, case laws, provisions in the articles of association of the company,

and the principles and policies involved in the determination of true and fair amount of profit.

Section 205 of the Companies Act contains provisions relating to declaration of dividend and ascertainment of divisible profit. There are also certain provisions elsewhere in the act connected with the question of divisible profit. All these provisions are stated in the following paragraphs.

### ***1. Profit after providing for depreciation***

Dividend can be paid by a company only out of current profits and past profits remaining undistributed, both left after the depreciation has been provided as per the provisions laid down by the Companies Act. Though, the Central Government keeping the public interest under consideration has the power to allow a company for declaration or payment of dividend. The dividend can be paid from any financial year in which the company earned profits.

As to how much depreciation should be provided for determining the divisible profit, Section 205(2) provides that depreciation must be provided in any of the following ways:

1. To the extent specified in Section 350.
2. In respect of each item of depreciable asset, for such an amount as is arrived at by dividing 95% of the original cost by the specified period.
3. On any other basis approved by the central government by which 95% of the original cost of each such depreciable asset can be written off on the expiry of the specified period.
4. In respect of other assets that are depreciable and for which no rate of depreciation has been laid down by the act or the rules made there and for which the Act and rules lays down no rate of depreciation.

### ***2. Grant by the government***

Dividend can also be paid out of money given by the central or state government for paying the dividend in undertaking of a guarantee provided by the government.

### ***3. Arrear depreciation***

If there is any arrear depreciation in respect of past years, it must be provided for out of current or past profits, before paying dividend for any financial year. In other words, if a company has not paid depreciation of any financial year that fell after Companies (Amendment) Act was commenced in 1960, then the depreciation must be provided before any declaration of dividend.

Such arrears of depreciation may be provided out of current profits or the profits of the previous financial years, remaining undistributed.

### ***4. Past losses***

Any past loss of the company must be set off against current or past profits or on both to the extent required by the Companies Act, before paying dividend for any financial year. If the company has suffered some loss in any of the previous financial year or the years after Companies (Amendment) Act, 1960 was commenced, then the lower of the following two amounts should be set off:

- The amount of the loss
- The amount of depreciation provided for that year or those years.

The amount should be set off against the following.

1. The profits of the company for the year for which dividends are proposed to be declared or paid, or
2. The profits of the company earned in any previous financial year or years that fell after providing for depreciation

### 5. *Exemption from depreciation*

Considering the public interest, the Central Government possesses the power for allowing any company to pay dividend out of current or past profits without making provisions for depreciation.

### 6. *Transfer of profits to reserves*

The current profit of a company arrived at after providing for depreciation can be applied for the payment of dividend only after transferring to reserves such a percentage of profit not exceeding 10% as per the prescription of the Central Government.

After the Companies (Amendment) Act, 1974 was commenced, a company is bound to handover a given percentage of its profit to its reserves before the declaration of dividend. However, there is no bar on a higher percentage and a company can voluntarily handover a higher percentage out of the profits earned, to the reserves according to the rules made by the Central Government in this context.

Table 8.1 depicts the prescribed rates of profit to be transferred to reserve according to the Transfer to Reserve Rules, 1984 as framed by the central government:

**Table 8.1: Prescribed rates of profit to be transferred to reserves**

Rate of Proposed Dividend	Amount to be Transferred to Reserves
Exceeding 10%, but not 12.5%	Not less than 2.5% of current profit
Exceeding 12.5%, but not 15%	Not less than 5% of current profit
Exceeding 15%, but not 20%	Not less than 7.5% of current profit
Exceeding 20%	Not less than 10% of current profit

However, no amount is required to be transferred to reserves, where the rate of proposed dividend is 10% or less.

### 7. *Dividend from Reserves*

The dividend could be compensated from the accumulated past gains of a firm kept in reservations in light of the rules made by the central authorities in this respect or together with the prior consent of the central authorities: Section 328(3). Section 205(3) added by the Companies Act, 1974 demands that dividend could be declared from reservations only about the rules made by the central authorities in this behalf. But where a provider wants to announce a dividend differently than according to these principles, it might do this with the previous approval of the central authorities. The charge balance, if any, highlighted at the gain and loss account will soon be accessible for a declaration of money without limitation if this balance was completed after charging depreciation, taxation, etc., in the last year(s).

The principles made by the central authorities in this regard supply that in the event of lack or inadequacy of profits in every season, a dividend may be declared by the business from accumulated past gains provided the following requirements are fulfilled.



The rate of dividend announced doesn't exceed the average of the prices in which dividend was announced by it at the five decades immediately preceding that year or 10 per cent of its own paid-up funding, whichever is less.

1. The entire sum to be drawn out of the accumulated profits earned in prior years and moved to the reserves doesn't exceed a sum equivalent to one-tenth of this amount of its paid-up capital and free reserves and the amount was so drawn should first be utilized to set off the losses incurred in the fiscal year prior to any investment in respect of equity or preference shares is announced.
2. The balance of reservations after such withdrawal doesn't fall under 15 per cent of its own paid-up share funds.
3. The sum in no way potential ought to be employed to cover the interim dividend.

#### ***8. Distribution of profit out of capital redemption reserve account***

If capital redemption reserve is made against redemption of preference shares, no dividend may be paid out of this book in future (Part 80).

#### ***9. Premium on redemption***

The premium that has to be paid when preference shares are redeemed shall be given for from the earnings of the business.

#### ***10. Other determining factors***

- ***Provision for taxation: Premium account (Part 80).*** No portion of the net benefit from the company can be redeemed for payment of money without making necessary provision for taxation because payment of income tax from company earnings is an ultimate response.
- ***Dividend out of capital profit:*** Except stocks premium, gain from forfeiture of stocks and profits before incorporation, funding increases could be implemented for payment of dividend, subject to specific conditions, including the following: Such gains must be realised gains. Articles of Association of the Firm will not contain any prohibitive provision pertaining to supply of these gains as dividend, and such gains must stay as a surplus following revaluation of all of the resources of the organization.
- ***Capital losses, intangible assets and fictitious assets:*** According to the bookkeeping and mechanical principles funding losses, intangible resources and fictitious assets ought to be written off from gains over a fair period, and a corporation should have individual policies regarding these writing off. Application of increase of payment of dividend could appear just after such regular yearly write off.
- ***Transfer of additional profits to reserve:*** The Directors of a business are permitted to move to reserves any extra quantity of gain or proceed any portion of profit, as they believe necessary, following a statutory transfer of earnings to reservations. The dividend could be compensated only from the equilibrium quantity of profit.

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## **8.4 MEANING OF DIVIDEND**

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The dictionary meaning of 'Interest' is "amount payable as interest on a loan or as a gain of a business to the creditors of an insolvent's property or an individual's share of it." But in commercial usage, however, the dividend is the proportion of the company's profit distributed among the members. So, company earnings and gains are not kept in

the company and spread among the shareholders, is called dividend. The term 'dividend' is also used to include distribution of the business's assets, in cash or in specie, which remains with the liquidator after he has realized all the assets and discharged all the liabilities, in the event of its winding up.

In *Commissioner of Income Tax vs. Girdhar Das & Co. (P) Ltd.* 1967 Instance, the Supreme Court Described 'Dividend' as: "As applied to a business that is a going concern, it generally means the part of the benefit of this company that is allocated to the holders of shares in the firm. In the event of winding it up means a branch of those realized assets among creditors and contributors depending on their rights."

Before the introduction of Sub-section (14A) at Section 2 of the Companies Act, the expression wasn't defined. Currently, by the part, dividend involves any residual income. This definition presumes that the phrase ought to be known only in its commercial sense. The Institute of Chartered Accountants of India has described dividend in its Guidance Notes on conditions used in financial statements as "distribution to shareholders out of profits or reservations out there for this function."

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## 8.5 COMPANIES ACT RELATING TO PAYMENT OF DIVIDEND

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The provisions of the Companies Act relating to payment of dividend are as follows:

1. The dividend shall only be payable in money. But this won't prohibit capitalization of profits or reserves of business with the aim of issuing entirely paid-up incentive shares or paying up any outstanding quantity of stocks held by the associates of the firm: Section 205(3).
2. Cheque or investment warrant can pay dividend payable in money. This needs to be sent by post direct to the registered address of those shareholders entitled to the payment of this lien. In case there are joint holders then the cheque must be sent to the address registered of one of representative investors whose names are first mentioned in the register of members or to such individual and to such an address on which the shareholder or the joint investors may in writing guide: Section 205(4)(b).
3. The department of business events has explained via its Circular No. 5/99 obsolete 12.5.1999 that dividend may also be transmitted digitally to the investors after receiving their approval in this respect and requesting them to nominate particular bank account number to that dividend because of them must be remitted.
4. Profit needs to be paid to the registered holder or his order or his or her banker. If a share warrant were issued regarding the discussion in pursuance of Section 114, the dividend would be paid to the bearer of this merit or his banker Department.
5. Dividend needs to be compensated, or the dividend warrant needs to be submitted within 30 days from the date of declaration of dividend, subject to specific exceptions: Section 205(4)(1).
6. Where a dividend was announced by a firm but hasn't yet been paid or the merit in respect thereof hasn't been submitted within 30 days by the date of this statement to any shareholder entitled to the payment of this dividend, each Director of the business shall, if he's knowingly a party to default, be punishable with simple imprisonment for a term that might extend to three decades and will also be liable to a penalty of ₹ 1000 for each default where such default continues. However, the provision as mentioned above isn't appropriate in the following conditions:
  - ❖ Where the dividend couldn't be compensated because of the performance of any law

- ❖ Where a customer has given leadership to the company concerning the payment of this dividend and those instructions can't be complied with
  - ❖ Where there's a dispute concerning the best way to receive the dividend
  - ❖ Where the dividend was legally adjusted by the business against any amount
  - ❖ Where, for some other reason, the inability to cover the money or to post the merit over the period aforesaid wasn't because of any default on the part of the firm
7. Any dividend, when announced, the amount thereof will need to be deposited in a different bank account within five days of the statement. The quantity of bonus deposited in another bank accounts as above shall be utilized for the payment of interim dividend. Section 205(1A).

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## 8.6 COMPANIES ACT REGARDING UNPAID AND UNCLAIMED DIVIDEND

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The provisions of the Companies Act regarding unpaid (unclaimed) dividend are as follows:

1. Where, after the commencement of the Companies (Amendment) Act, 1974 a lien was announced by a firm but hasn't yet been paid or claimed in 30 days by the date of this statement, to any shareholder entitled to the payment of this dividend, the organization shall, within seven days from the date of expiry of the said period of 30 days, move the entire quantity of dividend that remains unpaid or unclaimed into a particular account to be opened for the business in that behalf in any scheduled bank to be called "unpaid dividend account". Section 205A(1)
2. In case the default is made in shifting the entire sum referred to in Sub section (1) or any component thereof to the unpaid dividend accounts of the concerned business, the company will pay from the date of such default, interest at the rate of 12 per cent per annum and the interest accruing on such sum shall be utilized for the sake of the associates of the organization in proportion to the amount remaining outstanding to them. Section 205A(4).
3. The company will move any money transferred into the unpaid dividend accounts of business in pursuance of this segment that was not paid or claimed within the period of seven years since the date of such transfer into the fund called Investors Education, and Protection Fund established under Sub-section (1) of Section 205C.
4. If a business fails to comply with any of the requirements of the segment, the company and every officer of the business, who's in default, shall be punishable with a fine that might extend to ₹ 5000 for each day during which the failure persists. [Section 205A(8)].
5. Any individual claiming to be eligible for any cash transferred under Sub-section (5) of Section 205A into the general revenue account of the central authorities could apply to the central authorities for an arrangement for payment of the money claimed, along with the central authorities may, if satisfied, if on a certification by the business or otherwise that this person is entitled to the whole, or any portion of the money claimed, create an arrangement for your payment to that individual of the amount due to him after accepting such security from him because it might think fit. Section 205B.

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## 8.7 PAYMENT OF DIVIDEND OUT OF CAPITAL PROFIT

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Any individual claiming to be eligible for any cash transferred under Sub-section (5) of Section 205A into the general revenue account of the central authorities could apply to the central authorities for an arrangement for payment of the money claimed, along with the central authorities may, if satisfied, if on a certification by the business or otherwise that this person is entitled to the whole, or any portion of the money claimed, create an arrangement for your payment to that individual of the amount due to him after accepting such security from him because it might think fit. Section 205B.

Following are the examples of capital profits:

- Profit before incorporation
- Premium received on the issue of shares or debentures
- Profit on forfeiture of stocks and re-issue of forfeited shares
- Gain made available of fixed assets
- Profit on redemption of debentures in a discount

Section 205 of the Companies Act provides that dividend can only be paid from earnings. Gains can be equally earning profits and capital gains. Therefore the Companies Act doesn't offer any general limitation on the supply of capital gain as the dividend. Nevertheless, the next capital gains aren't available for the supply of bonus:

### *Premium on issue of shares*

According to Section 78 of the Companies Act, the premium on issue of shares is accessible only for certain specified purposes rather than for payment of money.

### *Profit on re-issue of forfeited shares*

According to Section I of Schedule VI of the Companies Act, the quantity of profit made on forfeiture of stocks needs to be demonstrated by adding into the predicted share capital of the business in its balance sheet, and the amount of such gain eventually abandoned after reissue of forfeited shares needs to be transferred to capital reserve.

### *Profit prior to incorporation*

A company comes into legal existence only from the date of incorporation. Thus, the profit gained during the time once the company wasn't in existence cannot be legally distributed as the benefit of the organization.

### *Profit from redemption of debentures at a discount*

A funding again gained in the redemption of debentures at a discount isn't readily available for distribution as dividend as was stored at the instance *Wall vs. London and General Provincial Trust Co. Ltd.* (1930).

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## 8.8 PAYMENT OF DIVIDEND OUT OF CAPITAL

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According to the Companies Act, no dividend could be paid from funds as it primarily provides in Section 205 that the dividend is payable only from present profit or beyond undistributed gains, arrived at after providing for depreciation. Consequently, if the memorandum or the articles of association even enable the company to declare the dividend from funds, such power gets automatically invalid. [*Verner vs. General and Commercial Investment Trust Ltd.* (1894)]

In the following circumstances, payment of dividend may amount to payment of dividend out of capital:

- If dividend is paid from the purchase proceeds of fixed assets
- If earnings are inflated from the next
  - ❖ Charging earnings expenditure to funding
  - ❖ Making lesser provisions for depreciation or obligations
  - ❖ Overvaluing closing inventory or investments
  - ❖ Increasing gain by another manner
- If a lack of funds proceeds and money is paid without making good this lack.
- Payment of dividend from capital suggests returning to the shareholder's portion of their paid-up share funds as the dividend.

The payment of money out of funds has the following effects:

1. The Directors might have right of indemnity from those that intentionally obtained dividend from the capital. However, they shed that right at which the directors signify that the dividend has been paid from earnings (Moxham vs. Grant-1990).
2. From the absence of questionable conditions, the Directors are not wrong in accepting that the reports and evaluation of responsible officers of the firm (Kingston Cotton Mills Co. – 1896).
3. The Managers are liable to make good the sum, which they've intentionally paid as the dividend from capital (London and General Bank – 1895)
4. After the payment of money from capital is then made high out of earnings, the Directors can escape accountability (Boaler vs. The Watchmakers' Alliance and many others 1903).
5. An auditor can't be held responsible for the negligence of responsibility because of his inability to discover payment of money out of capital if he's exercised reasonable skill and care and there are not any questionable circumstances for detection of deliberate enhancement of gain (Kingston Cotton Mills Co. Ltd. 1896).

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## 8.9 GENERAL GUIDELINES FOR DISTRIBUTION OF DIVIDEND

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Following guidelines govern the distribution of profit as dividend by a company in general way:

1. The dividend could be declared and paid only as long as the cash position of the organization is satisfactory.
2. A dividend shouldn't be compensated without creating a decent supply for depreciation on fixed assets.
3. Capital gains could be distributed as dividend only if these requirements are fulfilled:
  - ❖ The Articles of Association of the firm allow such a payment
  - ❖ Such funds gains have been realized
  - ❖ The excess stays even following the revaluation of all of the additional assets



4. If the profit and loss account contains a debit balance, the dividend is not meant to be distributed.
5. If goodwill or other assets have been excessively written down in the past, the surplus could be written back to profit and loss account, and dividend can be distributed from such gain.
6. The corporation should adopt a steady dividend pay-out ratio. It need not distribute all of the earnings to its shareholders as dividend.
7. Provision of the Businesses Act, Income-tax Act as well as the decisions of important legal cases need to be observed and complied with while announcing a dividend.
8. Capital losses, intangible resources, and fictitious resources ought to be written off within a period slowly to strengthen the fiscal position of the business.
9. The conditions of this Memorandum and Articles of Association have to be complied with before dispersing profit as dividend.

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### **8.10 ARTICLES OF ASSOCIATION REGARDING DIVIDEND**

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The conditions of this Articles of Association of a firm also need to be contemplated before distribution of profit as dividend together with the terms of the Companies Act. However, it could be said in this respect that no provisions as included in the Articles of Association supersede the requirements of the Companies Act. If a business does not have any content of its own, then it needs to stick to the provisions as included in Table A as a replacement for articles of association.

Regulations of the Companies Act describe the provisions regarding distribution of dividend by a company, which are given below:

1. All dividends shall be allocated and paid as per the proportions to the amount that has to be paid or credited to the stocks.
2. Clause 89: The Board has the right of deducting all amounts of cash that has to be paid from the dividend to any member, if any, currently payable by him to the firm due to calls, etc.
3. Clause 91: Any dividend, interest or other money payable in cash must be paid through cheque or warrant sent through article led to the registered address of the bankers.
4. Every such cheque or warrant shall be made payable to the order of the men to whom it has been shipped.
5. Clause 92: Any one or two or more joint holders of shares can provide effectual receipts for any dividends or bonuses payable in respect of such stocks.
6. Clause 93: Notice of any dividend which might have been declared will be supplied to the persons entitled to share therein in the way stated in the Act.
7. No dividend shall allow any interest against the company.

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### **8.11 AUDITOR'S DUTY AS REGARDS PAYMENT OF DIVIDEND**

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After dividend is announced, it represents a piece of accountability of the business enterprise. As stated above that Legislation of Clause 85 of Table A of 1<sup>st</sup> program claims that no dividend will be paid more than the sum of dividend declared.



However, this doesn't follow that the business must cover significantly less than what is announced. Accordingly, a company might be enticed by the shareholders for such payment as was held at the instance *Savern vs. Wye Railway Co.* (1896).

The duties of an auditor in connection with the payment of dividend are as follows:

- He must inspect the records of the enterprise to determine the various rights and privileges of the many types of their members.
- He must also analyze the minutes of both director's and shareholder's meeting concerning such payments.
- He should check the speed of volatility and warrant the rate in the context of the total amount of profit gained.
- He must see that the unclaimed dividends are moved to another bank accounts.
- He should obtain the register of members to justify whether dividend warrants are delivered to the proper persons.
- He must check the articles of association to validate the ability for such payment.
- He must confirm that the declaration of the dividend doesn't affect the working capital position of the business adversely.
- He must observe that the terms of the Companies Act relating to declaration and payment of a dividend (Section 205) duly comply with earlier statement and payment of dividend.
- He must ensure the fundamental principles of accounting and provisions concerning the transfer of reserves have been appropriately adhered to while arriving at the distributable profit.
- He should also consider the speed of interim dividend declared by the company and confirm that it's been found in the declaration and payment of the final dividend.

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## 8.12 PAYMENT OF INTERIM DIVIDEND

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The interim dividend is a dividend that's paid in respect of a year before the announcement of the final dividend. This usually means that it happens between two annual general meetings and the publication is accomplished by the Directors rather than the shareholders.

Sub-section (1A) of Section 205 enables the Board of Directors of a business to declare residual income. Clause 86 of Table A of Schedule 1 to the Companies Act provides that, "the board may from time to time pay to the member's such interim dividend as seemed to be warranted by the proceeds of the business." Usually, the Articles of Association of an industry gives this power to the board of supervisors. Until the departure of the Companies (Amendment) Act, 2000, there was no provision in the Companies Act (except Legislation 86 of Table A) about the interim dividend. The Companies (Amendment) Act, 2000 has introduced Sub-section (14A) at Department 2 where 'interim dividend' has become a part of the profit, and consequently, all terms of the Companies Act about volatility have become relevant to high-income also.

- The Board of Directors may declare an interim dividend, and the quantity of profit involving interim dividend will be deposited in another bank account in the period of five days since the date the declaration of such dividend has been made.
- The number of dividends requiring interim dividend so deposited over will be used for the payment of dividend such as the interim dividend.

- The terms found in Sections 205, 205A, 205C, 206, 206A and 207, as much as could be, also apply to interim dividend.

Frequently an auditor's information is sought at the subject of payment of residual income. After points must be considered by the auditor when guiding the direction:

- Interim profit and loss account ought to be prepared, if possible with a reasonable estimate of the final inventory.
- Where the closing stock value at the end of this interim period can't be fairly determined, a rough estimate of profit can be produced by implementing the gross profit percentage to revenue and deducting from such gross profit that the expenses so far.
- All alterations on account of bad and doubtful debts, depreciation, outstanding accountability, prepaid expenditures, etc., ought to be duly made to determine the fair profit for the interim period.
- The proportion of interim gain to be applied to the payment of interim dividend must always be about the conservative approach following consideration of the forecasts for the future months and the adjustments required for contingencies.
- A fantastic cash balance shouldn't be taken as a sign of gain with the aim of residual income. However, money is yet an additional choice element.
- An excellent cash position doesn't always warrant the cost of the interim dividend because the prospective capital requirement for all those functions might be rather considerable.
- It's the last bonus that needs to be announced after the final of the accounting year in a rate fairly greater than the speed of residual income. Consequently, it ought to be observed whether the corporation would have the ability to announce the final dividend in higher speed or not.

In paying interim dividend, the Directors undertake particular quantity of danger, since the interim dividend is, in reality, a lien in respect of the entire year and also for the year when there's a reduction, the payment of interim dividend will amount to payment of dividend from capital, where you will find insufficient accounts of reserves and surplus.

#### Check Your Progress

Fill in the blanks:

1. The share of profit earned by the company gets legally distributed to the stakeholder or shareholders of that company through the method of dividend is called .....
2. Company earnings and gains not kept in the company and spread among the shareholders is called .....
3. If a business does not have any content of its own, then it needs to stick to the provisions as included in..... as a replacement for articles of association.
4. All dividends shall be allocated and paid as per the proportions to the amount that has to be paid or ..... to the stocks.
5. The.....is a dividend that's paid in respect of a year before the announcement of the final dividend.

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### 8.13 LET US SUM UP

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- Profit may be defined, “as the increase in the net value of assets of a business over their net value at the commencement of a given period which has arisen other than by capital adjustment”.
- The share of profit earned by the company gets legally distributed to the stakeholder or a shareholder of that company through the method of dividend is called ‘divisible profit’.
- Dividend can be paid by a company only out of current profits and past profits remaining undistributed, both left after providing for depreciation in accordance with the provisions of the Companies Act.
- Company earnings and gains not kept in the company and spread among the shareholders is called dividend.
- The term 'dividend' is also used to include distribution of the business's assets, in cash or in specie, which remains with the liquidator after he has realized all the assets and discharged all the liabilities, in the event of its winding up.
- The dividend shall only be payable in money. But this won't prohibit capitalization of profits or reserves of business with the aim of issuing entirely paid-up incentive shares or paying up any outstanding quantity of stocks held by the associates of the firm: Section 205(3).
- The company will move any money transferred into the unpaid dividend accounts of business in pursuance of this segment that was not paid or claimed within the period of seven years since the date of such transfer into the fund called Investors Education, and Protection Fund established under Sub-section (1) of Section 205C.
- According to the Companies Act, no dividend could be paid from funds as it primarily provides in Section 205 that the dividend is payable only from present profit or beyond undistributed gains, arrived at after providing for depreciation. Consequently, if the memorandum or the articles of association even enable the company to declare the dividend from funds, such power gets automatically invalid. [Verner vs. General and Commercial Investment Trust Ltd. (1894)]
- An auditor must inspect the records of the enterprise to determine the various rights and privileges of the many types of their members.

The interim dividend is a dividend that's paid in respect of a year before the announcement of the final dividend. This usually means that it happens between two annual general meetings and the publication is accomplished by the Directors rather than the shareholders.

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### 8.14 LESSON END ACTIVITY

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Study the dividends pay-out of an organisation and also study what role does an auditor play in it. Prepare a report on the same and give a presentation on it.

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### 8.15 KEYWORDS

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**Profit:** It may be defined, “as the increase in the net value of assets of a business over their net value at the commencement of a given period which has arisen other than by capital adjustment”.

**Divisible profit:** The share of profit earned by the company which gets legally distributed to the stakeholder or shareholders of that company through the method of dividend.

**Dividend:** It is the company earnings and gains not kept in the company and spread among the shareholders.

**Interim dividend:** It is a dividend that's paid in respect of a year before the announcement of the final dividend.

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## 8.16 QUESTIONS FOR DISCUSSION

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1. What is profit?
2. Define the term divisible profit.
3. What are the principal determinants of divisible profit?
4. Explain the meaning of dividend.
5. Explain the Companies Act which relates to payment of dividend.
6. Discuss the Companies Act regarding unpaid and unclaimed dividend.
7. Explain the payment of dividend out of capital profit.
8. Discuss the payment of dividend out of capital.
9. Explain the general guidelines for distribution of dividend.
10. Explain the articles of association regarding dividend.
11. Discuss the auditor's duty as regards payment of dividend.
12. Discuss the payment of interim dividend.

### Check Your Progress: Model Answer

1. Divisible profit
2. Dividend
3. Table A
4. Credited
5. Interim dividend

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## 8.17 SUGGESTED READINGS

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A. Kumar, R. Sharma, *Auditing: Theory and Practice*, Atlantic Publishers and Distributors, New Delhi.

S. K. Basu, *Auditing: Principles and Techniques*, Pearson, New Delhi.

Ravinder Kumar, Virender Sharma, *Auditing: Principles and Practice*, PHI Learning, New Delhi.

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## LESSON

# 9

## INVESTIGATION

### CONTENTS

- 9.0 Aims and Objectives
- 9.1 Introduction
- 9.2 Investigation
- 9.3 Objectives or Purposes of Investigation
- 9.4 Features of Investigation
- 9.5 Working Methods
- 9.6 Duties of an Investigator
- 9.7 Investigation Report
- 9.8 Qualities of an Investigator
- 9.9 Difference between Investigation and Auditing
- 9.10 Procedure for Conducting Investigation in Auditing
- 9.11 Special Audit Techniques
- 9.12 Special Audit in Banking, Educational and Insurance Companies
  - 9.12.1 Educational Companies
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- 9.13 Let Us Sum Up
- 9.14 Lesson End Activity
- 9.15 Keywords
- 9.16 Questions for Discussion
- 9.17 Suggested Readings

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### 9.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Define the term investigation
- State the objectives or purposes of investigation
- Explain the features of investigation
- Understand the working methods
- Explain the duties of an investigator
- Discuss the investigation report

- Explain the qualities of an investigator
- Discuss the differences between investigation and auditing
- Explain the procedure for conducting investigation in auditing
- Discuss the special audit in banking, educational and insurance companies

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## 9.1 INTRODUCTION

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Along with routine inspection of reports of an enterprise's books, there might be an examination of records and their accounts of past years. To be able to examine records of documents and account of a venture, evaluation has to be performed. Investigation suggests an inquiry to company documents and the account, to achieve the objective. The inquiries' objective would determine the financial position, the ensuing position or the magnitude of the fraud. Therefore, an analysis is a distinctive sort of evaluation of records and accounts carried on by an investigator using a pre-determined objective in line with the necessity of the circumstance and involve something past, the affirmation of accuracy of data from the financial statements.

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## 9.2 INVESTIGATION

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An investigation can be described as a particular evaluation of an inquiry with a view to create a reality or to assess a condition of affairs to books of reports and related records or discover causes. As an instance, an investigation could be run to the account of a company whose business will be acquired analysis or by an organization might have to ascertain the magnitude of a fraud. From the view of Taylor and Perry, analysis entails inquiry into details behind the balances, i.e., to the technical, fiscal and financial position of the company organization. The investigation is a distinctive sort of evaluation of records and accounts carried on from the investigator using a function in agreement with the requirement of this situation and therefore are concerned more.

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## 9.3 OBJECTIVES OR PURPOSES OF INVESTIGATION

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The need of investigation may arise in many cases, but these are some of the circumstances where investigation is most frequently called for:

1. **For buying any organization:** Analysis can be run by someone on behalf of the client, once the client plans to buy a present company.
2. **For entry of a new spouse:** Investigation into the events of a venture company can be produced by any individual on behalf of their incoming spouse of a present venture enterprise.
3. **For hunting avenues of investment:** To be able to assess the fiscal solvency position of any company, an investigation could be accomplished. The financial solvency is quantified through analysis on behalf of a particular person who seeks paths of investment.
4. **For awarding financial or loan, Aid:** Investigation may also be performed on behalf of a lender or other financial institutions proposing to expand or grant loans to its own customer or change the terms and conditions of the same.
5. For suspected fraud in the event the operator or the direction suspects fraud, then they could appoint a lawyer to discover the fraud triggered from the workers.
6. For unnatural fluctuation of gain, analysis can be run on behalf of their proprietor or the managing of a company so as to determine the reason for abnormal fluctuation in benefit in the business enterprise.



7. For compensation of tax obligation analysis could be undertaken to the reimbursement of tax obligation or in certain instances for the discovery of undisclosed income of the assessee.
8. **For reimbursement of insurance claim:** In the event of the fire or other dangers, the businesses need to submit the claim to your insurance company to recoup the loss. The Insurance Provider can employ an accountant to ascertain the specific quantity of reduction for reimbursement of claim.
9. **For evaluation of goodwill and also stocks:** The stocks and goodwill of their company need to be appreciated on various events. To be able to figure out the fair value of stocks and goodwill, an analysis could be undertaken.
10. **For estimating sickness of a business device:** Authorities might have to consider a sick industrial unit and for this it might give appointment to an investigator to explore the cases of their ill unit.
11. **For those provisions of the Companies Act:** Section 235 to Section 251 of the Companies Act provide regulations to the analysis of any business under different special scenarios.
12. **For justifying neglect of the auditor:** In some instances, the auditors are held accountable for negligence in their own obligations. But before accusing auditors of negligence, the situation needs to be properly researched.
13. **For criticism by the bankers:** The analysis may also be undertaken with the direction on the basis of complaints made by the investors.
14. **For the cases of a hope:** Investigations are occasionally needed to be run on behalf of the beneficiaries of some faith to the cases of hope for suspected fraud. For the liquidation of the company analysis of suspected fraud or misfeasance from the Directors on behalf of the liquidator of a firm might also be undertaken.

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## 9.4 FEATURES OF INVESTIGATION

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An investigation is an assessment of accounting documents undertaken for a purpose of audit. Its goal is normally to detect and exhibit the reality in such a fashion that will allow the parties for whom it has been undertaken to draw conclusions and make their own decisions accordingly.

On the basis of an investigation of the definition, the following attributes of investigation could be identified:

Investigation is conducted with certain goals. It entails confirmation and examination of records that are particular. There are no statutory provisions or principles prescribed in the event of organizations except for evaluation. It's legal and voluntary. It is worried about the coverage issues but also restricted to evaluation of facets of an organization. It's undertaken, based on the character of the goal. In the majority of the scenarios, the courses of actions must be summarized with the investigator. Along with study and the analysis of these books of records and accounts examination of people may be undertaken. The reach of investigation long to cover many goals in line with the prerequisites of the circumstance or might be restricted to a certain goal. The researcher reports these person(s) who is/are responsible. From the analysis, the advice needs to be supplied in a way that is descriptive in addition to analytical.

In the instance of a personal evaluation, e.g., only undertaken on behalf of a potential buyer of a company, the inquiring agency needs to get accurate directions from his client regarding his conditions of reference the objective of analysis, the quantity of detailed work necessary etc.. These phrases of references have to be set out clearly in

a letter of participation. In the example of analysis ruled by statute, e.g., accounts for prospectus, the reporting agency has to be completely familiar with all the statutory regulations and must also acquire cardinal directions where that could be appropriate.

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## 9.5 WORKING METHODS

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Having clearly established the intention of the analysis, the investigator will initially make such preliminary questions as needed to determine the exact info that's required to allow him to organize his evaluation. He'll then draft a summary file, detailing the key words, which he can use in his closing report. These will vary based on the nature of evaluation being undertaken, however, when a company was being researched on behalf of a potential buyer, the key words can function as follows:

- The company and its history control and the employees
- Sales and promotion purchasers and providers
- Trading results according to audited accounts
- Future prospects and tendencies
- Assets and liabilities
- Conclusions and recommendations

After archiving the outline file, the investigator may undertake the detailed work needed to finish the investigation. This may typically be mostly composed of discussions and interviews with relevant people and perform on the reports and documents, but on each investigation, he'll have to exercise his decision as to precisely understand the job needs to be undertaken. Working papers will be well prepared, and out of those working newspapers, the last document will be composed. These working papers have to be carefully maintained. In the case of a dispute arising and neglect being alleged from the investigating accountant, then these working papers are important proof in litigation. After the evaluation is finished, the draft report will soon be finalized.

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## 9.6 DUTIES OF AN INVESTIGATOR

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The processes to be adopted in the analysis are contingent on the disposition of evaluation, its function and the conditions of the situation where the analysis has been undertaken. In most the instances of evaluation, certain precautionary steps are needed to be accepted by the inheritance. These steps are thought of as the responsibilities of the pupil, which he must follow in discharging his responsibilities conducting an evaluation. These responsibilities are provided below.

1. **Obtaining written education about extent and goals of analysis:** Before beginning an analysis, the investigator must obtain in the clear written instruction regarding the reach of the customer's job and intentions evaluation. In the event the customer is interested to enforce some restriction or limitation for his job, he must even put it in writing so that he may precisely ascertain the reach of his job and the essence of his or her duties. The time to be covered in the analysis also needs to be supported with the investigator by his customer certainly in writing. The interval is extremely important since the investigator may consequently restrict his evaluation of records and transactions to this period only.
2. **Framing analysis programme:** Depending on the goals, extent, and interval a successful investigation programme ought to be completed out. The analysis programme ought to be adaptive so that the investigator will make required modifications in the programme through real research. This flexibility in the

programme is essential because many measures in the analysis are contingent on the outcomes of the prior actions.

3. **Collection of Information Regarding the Small Business:** It's not feasible for the investigator to offer proper interpretation and coverage of this simple fact if he doesn't have the comprehensive understanding of the actions of this venture for which he's to run an investigation. Thus, before beginning his job of evaluation, the investigator must gather all appropriate details regarding the actions of the organization
4. **Enquiry Regarding the Standing of the Venture:** The investigator must make inquiries and gather info concerning the standing of distinct individuals operating in the business enterprise. Information also needs to be acquired regarding the goodwill of this organization. This info will assist the investigator a good deal in preparing his report.
5. **Taking specialist guidance:** The investigator should choose the help of experts throughout the evaluation, if needed, and consult with experts on matters where his knowledge isn't adequate.
6. **Reliance on records and accounts:** In the event, the books of reports and also necessary records are properly preserved, and the reports are audited, the job of the investigator becomes more simplified because he is allowed to rely on the written accounts and correctly preserved documents. So, normally, the investigator should avoid duplication of effort and focus more on these processes as will probably be more meaningful for analysis. However, the simple fact that the investigator has ever relied upon the audited books of reports must be contained in the analysis report.
7. **Preservation of working newspapers:** It's the job of the investigator to keep his working documents correctly. A comprehensive set of work completed, documents analyzed, pertinent data and evidence gathered, etc., must be held in this document together with signing statements, documents, and schedules. These working papers can help him in the time of finalization of record. These working papers may also be invaluable files in their own defense, even in the event the affected parties then struggle his findings.
8. **Care of secrecy and confinement to function:** The investigator must always remember the objective of evaluation, since the purpose of analysis will determine which documents and statistics ought to be analyzed in detail, which shouldn't be analyzed, for which instances detailed checking could be averted, what advice he must seek from resources apart from books and documents and what processes should he embrace in his analysis function. On the flip side, secrecy is the simple requirement of any evaluation. So, the investigator must keep the particulars of the investigation quite crucial.
9. **Care of minimum quality of work:** The investigator has to be honest and that he must approach his job with reasonable care, diligence, and skill. He shouldn't permit himself to be affected by other people, as complete independence is called for in the investigation. Thus, the investigator must constantly keep him free of the effect of interested men.
10. **Proper reporting:** The analysis report ought to be clear and unambiguous. The investigator must analyze the information and evidence gathered by him. He has to take good care to realize that his report doesn't comprise any incorrect details. Thus, before registering his report, he must carefully assess the articles of his account together with maintained working notes and papers. This is extremely vital as the erroneous report may fool his customer and encourage legal actions against him.

## 9.7 INVESTIGATION REPORT

The report on the investigation has to be carefully prepared. It ought to be utterly disgusting, quite clear in its significance as well as for as practicable from the given position. It should, nevertheless, give complete consideration to all of the factors impacting the choice to be produced. The kind of the record will typically be an introduction establishing the terms of reference and also the essence of the company being researched. A most important section is putting out the details determined and detailing the work done, and the last section is establishing the decisions and the recommendations. It needs to be recalled that the principal points of this report aren't obscured by particulars; some voluminous data ought to be relegated to appendices and referenced to the most appropriate region of the report.

Investigation report must contain all significant and related matters. He has to mention in his report what's necessary, ignoring what isn't essential. Truth and just facts should be introduced and nothing predicated on quotes ought to be provided. The investigator must mention in his account that the directions provided to him by his own customer concerning the analysis. He should mention that the limitations if any, place in the reach of his own work.

## 9.8 QUALITIES OF AN INVESTIGATOR

An investigating accountant must combine solid auditing methods, considerable expertise, sound judgment and a high comprehension of some business ventures. Due to the rough nature of the job, it will ordinarily be discovered that spouses and senior staff may personally execute a greater percentage of the job on evaluation compared to audits. The investigator should approach his work systematically. He must do the job honestly and diligently.

He must continue to keep the attention of his client on the very top and has to work with a sense of a service to this customer. The topic of the analysis is extremely specialized and normally a senior accountant having deep wisdom and experience acceptable for the occupation. He shouldn't be a chartered accountant, but he should have a solid understanding of accounting and auditing and technical understanding in regards to the several affairs of unique sorts of ventures. He has to be a person of proficiency and capability to comprehend different crucial matters obviously. He should have the capability to grasp things readily and communicate them in words that are clear. While conducting the evaluation, he should exert extreme care, ability and reasonable care keeping in mind throughout the objective of the investigation.

## 9.9 DIFFERENCE BETWEEN INVESTIGATION AND AUDITING

The difference between audit and investigation is outlined in Table 9.1

Table 9.1: Distinction between Audit and Investigation

Points of Difference	Audit	Investigation
1. Interested parties	Audit is conducted on the basis of the shareholders or proprietors.	Investigation is generally carried out on behalf of outsiders who intend to buy the business or who wish to lend amount and thus want to know the earning capacity or the financial position of the concern.

Contd...



2. Legal aspects	Audit is compulsory for a corporate business according to the Companies Act.	Investigation is not compulsory.
3. Inter-dependence	Audited accounts are not audited again except in case of special audit u/s 233 A.	Investigation can be carried out after the auditing of accounts has been completed.
4. Duration	The audit of accounts is usually for a year or six months.	The process of investigation may take up a time period of three years which can extend to seven years as well.
5. Depth of work	Audit is a kind of test checking.	Investigation is a thorough examination of the books of accounts.
6. Subject matter	Audit includes an examination of the books of accounts.	Investigation is not only an examination of accounts, but also inquiry into other factors, i.e., it goes beyond the books of accounts.
7. Computation of net profit	Audit is not related with the alteration of figures and introduction of adjustments to have net profits from different points of view.	Net profit or the actual earning capacity of the idea is ascertained by making certain adjustments in the net profit as calculated.
8. Purpose	Audit is conducted to know the true and fair view of the books of accounts.	Investigation is conducted to know the financial position and the earning capacity of the concern.

## 9.10 PROCEDURE FOR CONDUCTING INVESTIGATION IN AUDITING

The subsequent process is followed while running Analysis in auditing.

1. The directions of the customer about the character, extent, and objective ought to be getting in some and unambiguous conditions. If the directions are vague, then they may cause confusion and issues throughout the evaluation. The directions must cover the region of the evaluation, the objective of identification and the interval to be researched.
2. A diagnosis programme can't be rigid and fixed. Actual evaluation procedures at every stage need to be programmed, determined by the several improvements in the duration of this analysis.
3. The discovering of the prior steps will determine the additional course of analysis. While devising the analysis programme, the broad scope and limitations must be ascertained.
4. The listing of documents and records to be confirmed are to be set at this point keeping in view the purpose and aim of this investigation.
5. A comprehensive evaluation, i.e., evaluation of various documents and papers, and evaluation of different persons of this issue, about the analysis area should be conducted. At each point, the investigator can decide the additional course of analysis that depends on the situation and different findings. The investigator will maintain, a thorough listing of work completed, evidence analyzed, significant talks stored, etc., as proof for the analysis ran. The document preserved by the investigator together with the supporting records can form the basis for the formulation of preparation and conclusion of this analysis report.
6. The investigator could correlate all of his findings, examine all of the supporting statements and documents, completely analyze the investigation documents and conclude. While doing this, he should possess an open mind, free of pre-conceived thoughts.

### ***Contents of Investigations Report***

The investigator could draft the analysis report. The report might contain:

1. The goal and scope of analysis.
2. The time covered by this analysis.
3. The conditions of analysis about the written directions of their customer
4. The numerous constraints faced with the investigator which may materially impact the decision drawn ought to be mentioned.
5. The premise forms the cornerstone of analysis. The premise shouldn't defeat the very purpose of this investigation.
6. The analysis report must include headings, together with sub-headings, charts, graphs, etc.
7. The decision of the investigator ought to be mentioned and certain conditions should be imparted clearly.
8. The supporting files and data might be presented as appendices to document.

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## **9.11 SPECIAL AUDIT TECHNIQUES**

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Usually, an audit application defines the processes to become employed from the particular situation by concerning the methods into the various regions of bookkeeping. The confirmation technique is right regarding accounts, bank accounts or securities teeming along with other folks. Here, we will study a number of those processes in greater depth.

### ***Confirmation technique***

It is just a way of gathering audit signs that consist of information of the answer to a question. It could be intriguing to be aware that the AICPA included an affirmation of sundry debtors on its own Auditing specifications.

The process is appropriate in the event of creditors too. The auditor asks verification of lien by communicating with all debtors.

The Advice Note on Audit of Sundry Debtors, Innovations, and Loans has advocated that balances exceptional contrary to debtors and as advance and progress ought to be supported using a process of communicating with all the celebrations. The Advice Notice Stipulates the Subsequent:

- The assessing of their debtors' ledger accounts will not demand a contrast of their accounts from the ledger.
- Each account ought to be scrutinized to be able to complete exactly the 'aging' of their debtors. The debtors' program needs to have columns to signify that the duration where each account is more outstanding.
- The auditors should never automatically think that is realizable. Wherever debts have been composed, the auditor needs to meet himself if off the write has been founded on considerations of their facts.
- Debts usually include statements made by insurance businesses, transportation businesses, railways, etc., and also the auditor must ascertain that the assets are all realizable.

Correspondence ought to be understood to see if there's a likelihood of these own being said and if the statements are confessed.



They ought to really be displayed as suspicious, in case it seems that they aren't collectible. These guidelines may be implemented to creditors too.

1. Even the confirmatory letters ought to be routed outside over a period of 15 to 21 weeks of the conclusion of the calendar year, even whenever the audit is consumed much after with regard to accounts either because in the onset of this Balance Sheet or as at the following selected date ahead of the end of the season.
2. In case the range of accounts will be significant, letters could possibly be issued in respect of debtors and creditors. With checked and chosen account, your customer needs to be asked to organize bills of accounts revealing the place of the accounts. A nil stability accounts should be comprised.
3. The statements of accounts ought to really be compared with the auditor together with the accounts of debtors and creditors. He needs to sustain control before they've been still posted.
4. Either every single announcement of consideration should include a petition for affirmation of this equilibrium shown there or it needs to really be plotted using another letter from the auditor or your customer, as might have already been mutually agreed upon; either your correspondence, or the announcement needs to demonstrate the speech of their auditor to which the announcements of accounts subsequent to the verification should be returned. An envelope comprising the auditor's address and name needs to be enclosed.
5. Invoices or policies ought to be submitted underneath the oversight of this auditor.
6. In circumstances, a reminder ought to be delivered from the auditor. Letters acquired straight back undelivered needs to be sent in the tackle.
7. It needs to be confirmed, so the numbers affirmed may disagree together with the accounts and also that the accounts are confirmed. The customer ought to be asked where needed, to organize reconciliation statements.
8. In most scenarios, at which a reconciliation declaration was ready, it needs to be confirmed that the gap between the quantity affirmed and that exhibited from the novels of consideration really isn't the consequence of an omission to charge any sum acquired from your failure or party to debit with almost any sum of earnings or even to charge him with all the worthiness of products received by an opinion to respecting or pre-tax gain.
9. In case the distinction may be the consequence of a dispute or argue for return or allowable, etc., given into a celebration, it will be affirmed that there is a supply corresponding to this gap that ultimately might need to be imputed to him personally.

Verification procedure could be achieved both for sundry creditors and sundry debtors. Precautions in regard of creditors to be obtained will be as below:

- (i) The Creditors' ledger trial balance consented using the Management Account if any, earlier accounts are chosen to get affirmation and needs to be expressed by your customer.
- (ii) The supply designed for its total amount payable in respect of items received over the previous week at the year's end needs to be confirmed by evaluating admissions in items Inward sign up.
- (iii) A certification ought to be gotten by your customer that each one of the obligations that may have accrued around the day of this Balance Sheet is accepted into consideration.

Precautions in regard to sundry debtors to be accepted are as below:

- (i) The Debtors' ledger trial balance consented together using the management Account if any, until accounts are picked to get verification and needs to be expressed by your customer.
- (ii) Earnings generated at the end of the year's alteration ought to really be confirmed by evaluating the entrances in items outward sign up for a couple of weeks.
- (iii) The account must be checked with direct affirmation needs to really be settled on the grounds of inner control methods.

***Inquiry:*** Inquiries can vary between formally created questions handled to third events into informal oral questions handled by men in the thing. Replies to queries could offer that the auditor with information which he'd not already own or mightn't offer him together with corroborative proof. The demand for the question may emerge at each period of auditing. Wherever any transaction or entrance isn't readily evident, or its own impacts aren't readily clear, the auditor maybe not be unwilling to earn inquiry out of the proper official of their customer. Other than that, pupils should keep in mind that the auditor of an organization needs to earn an impression on his account, if he's acquired all of the information and explanations which he thought necessary because of his audit. This condition shows that question is just one of those procedures of the complete plot of auditing and consequently, the Businesses Act, 1956 has contributed specified powers into the auditor in Section 227 also continues to throw certain responsibilities on business leaders in Section 221. In any case, Section 227(1A) of the Companies Act, 1956 casts up on the auditor that a certain duty to investigate into individual chosen transactions. The way an auditor is predicted to perform the duty of inquiry is included in Section 227.

***Tracking:*** Tracking is made up of appearing in a procedure or treatment currently being performed by others, by way of instance, the auditor's monitoring of stock relying on from the thing's employees, or of their performance of command activities. Tracking offers audit signs in regards to the performance of the procedure or process, but is restricted by the idea at the time in which the monitoring occurs, and also from the fact that the act to be detected can change the method by which the procedure or method is performed.

***Analytical evaluation processes:*** Analytical inspection approaches could be defined as exams of advice made by means of an analysis of link and comparisons one of information.

Analytical processes incorporate the consideration of comparisons concerning the financial information of this entity together with advice for earlier periods.

Impacts such as budgets or predictions, or anticipations of this auditor, like an estimation of depreciation.

Industry Information, like a contrast of this thing's ratio of revenue to account receivable along with different factors of equal dimension in or together with business averages the exact business.

Analytical approaches need to be implemented to a degree for those purposes described in (a) and (c) over for several audits of financial announcements. In a few instances, furthermore, analytical systems may be efficient or effective compared to evaluations of specifics in cutting detection hazard to financial statement assertions.

### ***Analytical techniques before preparation the audit***

At the development period, analytical processes aid the auditor in understanding that the customer's firm and also in pinpointing areas of hazard by signaling improvements

inside the thing's firm of and areas of. This information is going to aid the auditor in specifying the type, timing, and scope of the audit processes. Analytical processes when preparing the audit utilizes information including the amount of products quantity of staff and sq. ft. of advertising area in details.

### ***Analytical processes utilized as Checks***

After creating and executing purposeful analytical processes, either independently or in conjunction with evaluations of information, as procedures based on SA 3301, the auditor will:

- (a) Describe the compilation of special purposeful analytical processes such as specified assertions, due to those assessed risks of material misstatement and evaluations of information, if any, for all these assertions;
- (b) Rate the reliability of information where the auditor's anticipation of documented quantities or ratios has been designed, due to origin, comparability, and temperament and value of information out there, and also controls more than preparation;
- (c) Grow an anticipation of documented numbers or ratios and also appraise if the anticipation is adequately accurate to recognize a mis-statement which separately or when aggregated with different misstatements, can bring about the financial statements to be materially misstated.

The extent of dependence on analytical approaches for audit

The dependability of information depends upon its own origin and temperament also is related to the situation under. The following are pertinent when deciding if the information is more reputable for functions of designing substantive analytical processes:

- (a) *Origin of this information.* For instance, data might be more dependable when it is accessed from separate resources beyond the entity;
- (b) *Comparability of that advice.* For instance, wide business information may have to get supplemented to become similar to this of a thing which sells and produces licensed goods;
- (c) *Character and value of this information.* For instance, whether budgets are demonstrated as outcomes to be anticipated as opposed to as targets to be attained; along with;
- (d) *Controls within the preparation of this advice* which can be intended to make sure accuracy, its completeness, and validity.

As an instance, controls on the preparation, inspection, and upkeep of budgets.

### ***Analytical Approaches which help when contacting a summary***

This system was reviewed in the PCC degree. Given need for this particular technique from the circumstance of growing diversities, complexities, and quantities of industry, it needs an even more in-depth treatment from the field of ratio investigation and associated issues.

It ought to be appreciated that the audit program will probably be realistic following the auditor has changed from this nation of central controllers operating from the business enterprise and the light of the adventure of their fluctuations.

In the event the auditor could comprehend several of the imperatives below as well as the connection of their firm with all the market and surroundings, then he'd have the ability to earn the audit programme target.

Conflict of inflation, interests, inter-company connections, lack of requirements, property economy, get a grip on the condition are a number of the forces which state an organization's functioning and direction strategy to your huge scope.

Even the auditor usually plays with an audit by setting reliance. Even a provider's management system can give a maximum hauling of the specific raw-material although in case the raw materials is really a regulated product and also the source is more intermittent, it's clear that the interior control principle regarding the minimum or maximum retaining of this raw substance isn't of any use for this control that can be involved about the conducting of the company.

When the business is allocated a lien or license for this stuff no matter the consideration, the same will be availed of by the direction. Aside from in the event, the substances are required the direction isn't going to obey to procure stuff by the market at a high price not the same as the price that is restricted.

For products, it's frequently the clinic to require and receive an import permit to get a quantity than is needed to prevent the red tape. Internal control systems will probably be no usage soon at these circumstances.

*The relevance of Ratio and development Evaluation:* Ratio investigation is a significant nutritional supplement to this audit approach that gets the virtue of attracting to concentrate deviations, that the abnormalities and versions that are surprising. A ratio measures the size of 2 factors. It will not possess some meanings of its own apart from to give substance. It's a method diagnose or to assess the business' health. Even the auditor sometimes takes a perspective of this data below audit by embracing ratio investigation. They could check if the information remains valid, legitimate and consistent. Via the practice of ratio investigation, any partnership between 2 topics that are related is inclined to become revealed. It presupposes specific quantity of comprehension about the area of the auditor on that which is the association.

This could be gotten from the auditor out of the understanding of the connections or by expertise, and his understanding gained elsewhere. In case there's the connection that is known that is definite, the thing will become more straightforward.

There could be situation, e.g., recently appointed personnel aren't eligible to Provident Fund gain for several stages or there can be a few retired individuals reemployed those aren't eligible to some Provident finance gain.

Thus, it could be noted that ratio investigation which makes it feasible for your auditor to find troublesome areas that can then be exposed to scrutiny to verify that the issue exists or it really is a reflection of an actual abnormality which firm has undergone throughout the time included in the audit.

Before damage has been achieved by it in forestalling an impending threat, this will help. It's believed that though, in the audit preparation period, the statistics have been exposed to ratio investigation; the auditor is at a place to organize his audit programme intentionally.

He'll find a way to dedicate a suitable period of effort and time where abnormalities are discovered. The study of ratios and associations contains two stages:

1. The decision making and measurement of both varies and also inter-connections within statistics.
2. The examination, evaluation and explanation of all their conditions in light of their value along with these changes.

It's been mentioned before that information needs to be interrelated for practically any ratio investigation. Outside of that, specific companies have their particular capabilities

An organization with earnings amount in a minimal margin of benefit is now predicted to possess a higher stock turnover ratio. In the event the ratio is low, then it's going to be soon described as a pointer for the probe.

A firm offering income reduction for immediate settlement of balances are going to have top debtors' turnover ratio. An organization working using a needed stuff will possess buyer's progress rather than some debtors' accounts.

In an organization where authorities would be your customer, about the flip side, it's the nature which the gross profit of benefit will be elevated and also the debtors exceptional quite substantial.

For that, auditor to realize the consequences of ratios, for example, qualifications, expertise is critical.

The auditor is anticipated to contain the wisdom of relationship between variables from the firm he is auditing therefore he can assess variation and can distinguish deviation.

This comprehension could be originated from compared together with the previous information of the business or from mention of data offered regarding the industry out of some origin or simply by assessing the information seen within some other company participated in most similar conditions at the lineup of business.

The information is thought of as separate and objective. These need to be employed in combination with discretion. Procedure and the cornerstone of compilation, the time scale covered and also an author and the source of all their information are a number of the considerations until they've been useful for the comparisons necessary.

The Reserve Bank of India Bulletin the Calcutta Stock Trade Directory, "Industrial Manual" and 'Kothari's Financial Accounting' are a few of the books that contain financial information regarding companies. But they must perhaps not be thought to be a ready-made cloth for contrast as the mode of compilation and the conditions, etc., can be reminiscent. The theme can be properly used for contrast.

A lot of the ratios called people may be properly used by the auditor in evaluating details of the wellbeing of the difficulty.

The auditor needs to be proficient and experienced enough to understand precisely what ratio is suitable because of his intent and exactly what they'd disclose and to associate things; additionally, what's anticipated as a consequence of ratio.

By way of instance, to understand perhaps the relation that is average is born by the problem's price of earnings to earnings, the auditor may calculate profit ratio.

In the event, the gross revenue ratio indicates some other abnormality, relying on the abnormality inference could be attracted for confirmation and verification. In the event the gross earnings ratio is significantly more than ordinary, the chances of risk that instantly occur if your:

- (i) earnings over stated,
- (ii) inventory or more appreciated
- (iii) buy under-stated,
- (iv) salaries and different prices payable, etc..



The auditor faces difficulty solving the issues. He may assess to determine specific predicaments that prevail or perhaps the doubts have been authentic.

Additionally, it is natural to its auditor you may anticipate the ratio of revenue unless clarified by unexpected things to become upward in such situation. As an instance, the distribution and selling interest or cost of borrowings may have gone to eat the perimeter of earnings up.

Simply take the following instance: assume the turnover ratio (Sales/Capital) exhibits a substantial progress during the past year and there isn't any concurrent gain in the solvency or liquidity ratios.

The auditor must investigate the reason. It is possible that the business has evolved a method of direction. It's likewise feasible that:

- (i) Earnings are inflated or
- (ii) That the credit score policy has been faulty to lead into tremendous accumulation of debtors
- (iii) There'd been defalcation of earnings proceeds.

You'll find certain qualitative ratios that might be especially valuable to this auditor, e.g., and the ratio involving your primary raw materials used in total manufacturing can establish both the amounts.

Auditors may work with lots of additional ratios including the ratio of person hours to validate the validity of statistics from the Balance Sheet and the Gain and Loss Account.

It might, therefore, be found that by working-out ratios, the auditor can spot regions where people are named to get. Much like, your doctor, turns outside an identification also outward symptoms are examined by him, diagnoses them. This sort of process can prove useful when utilized towards the assurance and article audit.

Ratio analysis is of wonderful usage for checks. This must be anticipated which amounts of earnings will change jointly with fluctuations on buys, wages and bills, etc. Nevertheless, the mutual partnership on the majority of related characters may vary only because of extraordinary circumstances, favourable or unwanted.

Working out the connection of ratios, so, and evaluating them along with the preceding decades, equal ratios serve to ascertain the apparent reasonableness of these characters.

In the scope reasonableness is set, the auditor may feel to be on a business ground if he points his name. It needs to be mentioned that ratios are one of those manners of the app of overall evaluations.

### ***Evaluating consequences of Analytical Processes***

In case analytical procedures completed by the SA identify fluctuations or associations that are conflicting along with additional related information or that differ in expected values by a significant amount, the auditor will investigate these differences by:

- (a) Inquiring management and receiving proper audit signs relevant to administration's answers; along with
- (b) Performing additional audit procedures as necessary in the circumstances.

Additional investigation, by means of audit processes made to produce a satisfactory decision, would be required when the direction is not able to provide an explanation or if the explanation isn't regarded as adequate.



### ***Analytical processes used in the overall audit***

The auditor will look and carry out analytical processes close to the end of the audit which assist the auditor when forming an overall decision as to whether the financial statements are in accordance with the auditor's knowledge of the entity.

### ***Statistical Sampling in Auditing***

The audit signs should, in complete, enable the auditor to make an opinion regarding the economic details.

In forming this kind of impression, the auditor does not commonly analyze most of the information that can be found because they could reach a decision concerning a free account balance, class of transactions or a control by way of judgmental or statistical sampling methods.

Statistical sampling technique is increasingly getting popular with all the auditors. Statistical sampling in auditing stands to get the technique of forming an opinion about a set of goods about the basis of an evaluation of a couple of the products.

It might be recalled that test assessing procedure is just one of those acknowledged auditing methods, which nearly all of the professional bodies of the planet, which includes the Institute of Chartered Accountants of India have recommended for use by those members to the right consideration of facts along with applicability.

We also have seen the consequences of this test check procedure as a basis for forming knowledgeable notion regarding the reports below audit.

Statistical sampling technique could be considered as a tasteful use of the test check procedure that has all the advantages of the latter with the shortcomings taken out.

The supreme virtue of statistical sampling procedure is located in its relies on the statistical idea of potential.

It's however, not as simplistic as the evaluation tests.

To the basis of this audit performed out, an auditor is required to give an account featuring his opinion, regarding accuracy and fairness of the bookkeeping statements.

In expressing his ruling, the auditor by no means guarantees the absolute precision of their accounting statements; however, he chooses a possibility to be challenged concerning the legitimacy of their own opinion. Even after a complete assessing, he cannot be sure that the accounts and also the consequent bookkeeping bills are clear of error, manipulation, fraud or blunder.

On the other hand, the ruling he conveys signifies his general evaluation of the accuracy and fairness of this accounting statement predicated upon his satisfaction which he's got implemented all expert skill at his mastery to find that no substance fraud or mistake exists to distort the authentic and fair view of their accounting claims.

After he checks just a portion of their entire bookkeeping information instead of assessing all the information, it is clear that the amount of gratification obtainable in the latter wouldn't be available;

### ***Some more Special Audit Techniques***

However, a little loss of the level of gratification will probably undoubtedly be more than paid off by the appreciable savings in time and costs of being assessed only a small per cent of the overall data.

It's again true that larger the sample, the more would be the gratification, however out of the practical consideration the minimum requisite sample size, even when

determined mathematically will likely be adequate to express an opinion in regards to the overall truth and equity of this total data contained in an affordable range of precision and with decent assurance.

It is crucial to recognize that one analyzing procedures don't come inside the meaning of sampling. Tests performed over 100 per cent of the items within people don't involve sampling.

Likewise the procedure of picking out all of items inside a population which have a particular significance (e.g., all of items over a sure volume) does not qualify as sampling connected to the portion of the population analyzed nor with regard to the population as a whole, since the products weren't chosen from your overall populace on the basis that has been likely to be more representative.

Such goods might imply some characteristic of this rest of the part of the populace but would not possibly be the cornerstone for a legal conclusion in regards to the rest of the portion of the populace.

### ***Reach the particular audit aim***

For tests of controls, no specific projection of deviations is essential since the sample deviation speed will also be the projected ideology rate for its population.

### ***Risk-Based Audit***

The audit needs to be risk-based or focused on aspects of maximum hazard to this success of their audited entity's objectives. Risk-based audit (RBA) is a means to audit which analyzes audit challenges, sets materiality thresholds centered on audit risk evaluation and develops audit programs that allocate a larger percentage of audit resources to high risk places.

The auditor does not normally will need to carry out special audit methods to all areas of audit. He only needs to look audit programmers and procedures in areas sooner defined as main risks that may lead to the financial statements being materially misstated.

RBA is a vital portion of monetary audit equally from the illustrate audit of their financial statements and in the audit of financial systems and trades involving investigation of inner controllers.

It concentrates primarily upon the identification and assessment of the financial statement misstatement dangers and offers a framework to lower the affect to this fiscal assertion of those recognized risks to an acceptable amount before rendering an opinion on the financial statements.

In addition, it provides indicators of dangers based on opportunity for the progress of audit hazard management and control processes.

This affords a chance to this audit to increase its operations from tips about risks which don't have a current impact on the financial statements however impression. the audited entity's operational plans and performance within the lengthier duration.

### ***Audit hazard investigation***

The auditor needs to perform an analysis of the audit challenges that impact on the auditee ahead of endeavour specific audit methods, Risk assessment can be a subjective process. It is part of the professional conclusion of auditor and of the particular conditions.

***Audit risks are caused by fraud and error:***

Is a mistake can be considered not intentional if it is mainly an output of omitting, as when valid transactions and/or balances are excluded from your financial statements; or from the commission, even as when wrong trades and/or balances are comprised of the financial statements?

Fraud is an intentional misstatement from the accounting information or supporting records from which the financial statements are willing. It's meant to deceive financial statement users or to conceal misappropriations.

The auditor has the obligation to programme and execute the audit to get reasonable assurance about whether the financial statements are free of material misstatements, whether due to fraud or mistake.

An error hazard may emerge from an error in theory, estimate, essential advice processing, financial reporting process or disclosure.

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## **9.12 SPECIAL AUDIT IN BANKING, EDUCATIONAL AND INSURANCE COMPANIES**

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The following important factors must be noted for auditing an Account of a Banking Firm:

***General***

- The auditor needs to begin with affirm that his appointment is so.
- He must observe that Annual Accounts of the banking firm are prepared in an appropriate form.
- He must analyze the method of internal control and check and also determine whether such a procedure is sufficient or not. Usually, banks have another audit section for the evaluation of daily transactions. The efficiency of this system ought to be analyzed.
- He must pay a visit to the lender on the last operating day of this year to rely on the money himself. If the money was retained using the Reserve Bank of India or some other lender, he must get a certificate verifying the deposit.
- He must especially assess the reception of drafts, cheques, etc., over the final working day that hasn't yet been entered in the novels.

***Income***

- He must confirm income and investments there from. It needs to be noticed that investments are correctly appreciated.
- He must vouch that the interest rates and advances and make sure that irrecoverable curiosity is adequately provided for.
- He must confirm bills discounted and also discount obtained about these invoices. It's to be determined the lien on bills ignored and unmetered invoices has been taken forward.
- From time to time, a banking provider receives a commission from its clients for services rendered by them. If that's the case, such a commission obtained must be vouched by proper vouchers.

- He must confirm the securities deposited with the lender for secure custody purpose and also see that earnings in respect thereof have been correctly accounted for

### ***Expenditure***

- He must observe that capital expenditure has been properly handled in the novels and the suitable distinction was made between capital and earnings.
- He must assess the equilibrium of Current Account, Fixed Deposit, and Savings Bank Ledgers together with the programs obtained in the customer and determine that all interests are excellent on deposits, was given for.

### ***Miscellaneous***

- All assets and liabilities need to be confirmed and it ought to be noticed that sufficient provision was made for doubtful and bad debts. He must especially check the overdrafts, etc.
- He must analyze the Branch Returns and make sure that they're correctly integrated from the Head Office novels.
- He must go through the particulars of Secret Reserves, if any, preserved and see that their objective is real.
- He must determine the adequacy of Securities in respect of all loans and improvements in both circumstances, entirely secured and partially secure.
- He must guarantee that 20 per cent of earnings before paying money are moved into the Reserve Fund as necessary under the Act.
- He must observe that the terms of Secs. 11-20 (Stated previously) from the Banking Companies Act are fully complied with all the regulations.

### **9.12.1 Educational Companies**

Audit of educational institutions such as schools, colleges etc., or other similar organizations that are engaged in the instructional area is referred to as audit of academic institutions. The auditor should check income and expenditure accounts and balance sheet of these institutes to be able to confirm and report the accurate and equity of outcomes presented by earnings statements and financial situation introduced by the balance sheet. Normally, the procedures and processes of vouching and auditing is the same still an auditor of an instructional institution should execute following tasks:

1. The auditor is supposed to acknowledge the University Act and take a note of Trust deed and the rules and regulations laid down in relation to accounts. A resolution can be passed in certain intervals of time which concerns auditors, by the Governing body. The auditor must have access to the copy of minute books so that he can have a confirmation regarding the compilation of decisions made by Government or any other Governing body.
2. A copy of financial statements or budget must be accessed by the auditor in order to have knowledge about the various sources of income and expenditure.
3. The effectiveness of internal check must be assessed by the auditor in a detailed manner.
4. The grant-in-aid provided by the Government must be vouched by the auditor with utmost care.

5. The receipts of fees from students paid every month, and the counterfoils of those receipts must be verified by the auditor personally. He must also keep a check on deposition of cash received in the bank is done on a daily basis or not.
6. The auditor is bound to make a verification of charges apart from fees. These charges may include the fees charged for examination, for laboratory and other fines or penalties on the student's behalf.
7. In case the fees of any student are received by the institution in advance, the auditor must make sure about its adjustments.
8. An authorisation from the concerned authority must be checked in case of fee concessions and other charges. In case any charges can't be recovered then until the recommendation by concerned authority is received should not be written off.
9. It must be checked and verified that the purpose for which grants-in-aid and other funds have been received by the Governing body are utilised for the same purpose and not otherwise.
10. In case of donations and other subscriptions received from any authority, this must be accounted and acknowledged by the auditor.
11. A proper verification must be carried out by the auditor using the vouchers related to income from property, investment, etc.
12. The auditor must perform vouching for making sure that the salary is regularly paid. He must access the Salary Register to carry out vouching and in cases of increments provided to any employee must be sanctioned appropriately.
13. The auditor must verify that the provident fund is duly provided to the staff and is invested according to the rules laid down for same.
14. The auditor must carefully vouch the expenses spend on establishment and check that there is no mistreatment of capital expenditures in the name of revenue expenditures or the other way around.
15. An auditor must verify if the scholarship has been duly paid or not. The verification can be done by comparing student's receipt and the Scholarship Register maintained by the institution.
16. The balance sheet must properly expose all the assets and liabilities.
17. The verification of stock of equipment, stationary or furniture of the institution must be carefully done.
18. The deduction of income tax must be carried out while paying the salaries to the staff. The deduction made must be duly deposited at the Income Tax Department.

### **9.12.2 Insurance Companies**

Following special points must be considered while performing the audit of an Insurer:

General Auditor first of all needs to study the applicable terms and conditions of the insurance policy act governing the insurance provider. The auditor should assess the internal control system of this thing. He must decide up that to what extent he could rely on this system. He must check the minutes of this meeting of the shareholders and board of directors. He must check the records about the securities deposited with the reserve bank of India. It ought to be guaranteed that in the planning of their yearly accounts the rules and also a supply of the insurance policy act and companies behave have been adopted.

### ***Receipt***

The most important source of income of an insurance carrier is the receipt of premiums from policyholders. The auditor should view these attentively. Outstanding premiums ought to be brought into the books of accounts. Premiums received in advance ought to be brought to the balance sheet as an asset and shouldn't be revealed as income of this year. Another source of earnings could be rents, interest, and dividends on investment. It needs to be assessed carefully.

### ***Payments***

The largest expense of an insurer organization is that the payment of claims about the policies. The auditor should check these very carefully. Claims confessed but not paid until the balance sheet date ought to be shown as a liability on the balance sheet. Other heads of cost ought to be assessed with their various vouchers.

### ***Balance sheet***

The auditor should assess the resources and liabilities appearing on the date of this balance sheet. It needs to be verified that they're displayed at the right price. Appropriate depreciation must be provided for about the resources. Proper provision should be made to the unexpired hazard on the policies, which might draw in claims later on.

#### **Check Your Progress**

Fill in the blanks:

1. An \_\_\_\_\_ can be described as a particular evaluation of an inquiry using a view to creating a reality or to assessing a condition of affairs to books of reports and related records or into discovering causes.
2. Before beginning an analysis, the investigator must obtain the \_\_\_\_\_ clear written instruction regarding the reach of his job and intentions of evaluation.
3. The topic of the analysis is extremely \_\_\_\_\_ and normally a senior accountant having deep wisdom and experience acceptable for the occupation.
4. Audit is conducted to know the \_\_\_\_\_ of the books of accounts.
5. Investigation is conducted to know the \_\_\_\_\_ of the concern.

### **9.13 LET US SUM UP**

- An investigation can be described as a particular evaluation of an inquiry using a view to creating a reality or to assessing a condition of affairs to books of reports and related records or into discovering causes.
- An investigation is an assessment of accounting documents undertaken for a purpose it is an audit. Its goal is normally to detect and exhibit the reality in such a fashion as will allow the parties for whom it has been undertaken to draw conclusions and make their own decisions accordingly.
- Having clearly established that the intention of the analysis, the investigator will initially make such preliminary questions as are needed to determine the exact information that's required to allow him to organize his evaluation.



- The processes to be adopted in the analysis are contingent on the disposition of evaluation, its function and the conditions of the situation where the analysis has been undertaken.
- The report on the investigation has to be carefully prepared. It ought to be utterly disgusting, quite clear in its significance as well as for as practicable from the given position.
- An investigating accountant must combine solid auditing methods, considerable expertise, sound judgment and a high comprehension of some business ventures
- Audit is conducted on the basis of the shareholders or proprietors. On the other hand, investigation is generally carried out on behalf of outsiders who intend to buy the business or who wish to lend amount and thus want to know the earning capacity or the financial position of the concern.

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### 9.14 LESSON END ACTIVITY

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Study the investigation process and audit process of an organisation. Determine the differences between the two. Prepare a report on the same and give a presentation on it.

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### 9.15 KEYWORDS

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**Investigation:** It can be described as a particular evaluation of an inquiry using a view to creating a reality or to assessing a condition of affairs to books of reports and related records or into discovering causes.

**Investigation report:** It is the report that contains the details about an investigator performed

**Audit:** It includes an examination of the books of accounts.

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### 9.16 QUESTIONS FOR DISCUSSION

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1. What is investigation?
2. State the objectives or purposes of investigation.
3. What are the features of investigation?
4. Discuss the working methods.
5. Explain the duties of an investigator.
6. Discuss the investigation report.
7. What are the qualities of an investigator?
8. What are the differences between investigation and auditing?
9. Explain the procedure for conducting investigation in auditing.
10. Discuss the special audit in banking, educational and insurance companies.

#### Check Your Progress: Model Answer

1. Investigation
2. Customer
3. Specialized
4. True and fair view
5. Financial position and the earning capacity

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## 9.17 SUGGESTED READINGS

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A. Kumar, R. Sharma, *Auditing: Theory and Practice*, Atlantic Publishers and Distributors, New Delhi.

S. K. Basu, *Auditing: Principles and Techniques*, Pearson, New Delhi.

Ravinder Kumar, Virender Sharma, *Auditing: Principles and Practice*, PHI Learning, New Delhi.