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AUDITING

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BLOCK I INTRODUCTION TO AUDITING

*Introduction of
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1.0 INTRODUCTION

The word audit is derived from Latin word audire which means to hear. In middle ages whenever the owners of a business suspected fraud they appointed certain persons to check the accounts such as a person sent for the accountants and heard whenever they had to say in connection with accounts. It was an Italian Luca Pacioli who first published his treatise on double entry system of booking for the first time in 1494. He mentioned and described the duties and responsibilities of an auditor. Since there have been a lot of changes in the scope and definition of audit and responsibilities of an auditor Preparation of accounts is not the duty of an Auditor. "Auditing begins, where accountancy ends". Auditor is only concerned for checking and verification of records. Auditor is a qualified person appointed for the purpose of certification of work done by others.

1.1 OBJECTIVES

Students would learn the rudimentary aspects of auditing.

1.2 DEFINITION

Auditing in India has been described in different ways

"Auditing is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the

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Auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis, formulates his judgment which is communicated through his audit report.”

- **The Institute of Chartered Accountant of India**

Another definition goes as such

“Auditing is an intelligent and critical scrutiny of books of accounts of a business with the documents and vouchers from which they have been written up, for the purpose of ascertaining whether the working results of a particular period as shown by Profit and Loss Account and also the financial position as reflected in the Balance-sheet are truly and fairly determined and presented by those responsible for their compilation.”

- **J. R. Batliboi**

1.2.1 FEATURES OF AUDITING

The following are the features of auditing :

- 1 An independent, scientific intelligence and critical examination of books of
- 2 Accounts and records of business
- 3 Detection of errors and fraud, if any
- 4 conduct of audit by an independent person or by body persons qualified for the job
- 5 Use of special technique, standard and procedures
- 6 Ensuring the corrections authentically and reliability of accounting information

1.2.2 Accountancy and Auditing

The difference between Accountancy and Auditing is as follows :

1. Accountancy is mainly concerned with the preparation of summary and analysis of the records prepared by the book-keeper for this, an accountant has to prepare trial balance and then annual accounts. On the other hand, Auditing means the verification of book entries and accounts to find out their accuracy. So the auditor’s work is to find out whether the final accounts exhibit a true and fair view of the state of affairs of the concern or not and to report his findings to the share holders.
2. An accountant is an employee of the business while an auditor is an independent outsider.
3. As an employee of business, an accountant draws his monthly salary regularly from the business itself while an auditor is paid a remuneration agreed upon between him and his client
4. An accountant is not expected to have a knowledge of auditing but for an auditor, it is very essential to possess a thorough knowledge of accountancy.
5. An auditor can be changed from year to year but an accountant is not, as he is usually a permanent employee of the business.

1.2.3 Scope of an Audit:

- a. Safeguards the financial interest of persons who is not under management of the entity, i.e., partners or shareholders.
- b. Acts as a moral check on the employees from committing frauds and errors.
- c. Helpful in setting liability for taxes, negotiating loans and determining the purchase consideration for a business.
- d. Useful for setting trade disputes whether it is a matter of performance bonus or increment or it is claim for the damages due to fire or other accident.
- e. Discover the areas of wastages and losses occurring due to the absence or inadequacy of internal checks or internal control measures.
- f. Audit report generally state the fact that whether proper books of account and related records have been properly kept so as to make the deficiencies or inadequacies good in this respect.
- g. As an appraisal function, audit reviews the existence effectiveness and continuity of various controls in the organizations and reports weaknesses, inadequacies, etc., in them.
- h. Audited accounts are of great help in the settlement of accounts at the time of admission or dissolution or death or retirement of partner.

1.2.4 Independent Audit and its Objectives

An independent audit is an appraisal conducted by a third party with the aim of establishing and assessing a company's accounts, business transactions and finance records. Independent auditors, also known as external auditors, are not employees of the company -they are accounting professionals contracted for their services. Companies often use independent auditors instead of internal auditors to avoid potential conflict-of-interest situations. The goals and objectives of an independent audit process vary with different companies. However, most audits are geared toward the same end.

Examine Financial Statements

One of the primary goals of an independent auditor is to examine the company's financial statement to ensure the financial books are accurate and compliant with fiscal laws and regulations. Independent auditors inspect the accounting system and account books of a company for accuracy. Auditors also compare their financial assessment with a company's corporate financial reports. External auditors are permitted to publicly release the results of their evaluation.

Make Recommendations

During an independent audit, auditors are given free access to all of the company's financial statements. Because of this, most auditors become very familiar with their client's accounting and management policies. This gives them a clearer picture of the company's possible financial flaws. Based on this, auditors can offer recommendations on how a company can improve its accounting methods.

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Attestation Engagement

Another common objective behind an independent audit process is an attestation engagement, a scenario where a company hires auditors to evaluate an earlier report or analysis conducted by the company. The auditors' report is then presented in the form of a written or sometimes oral report. After the evaluation is complete, the auditors' final report must comply with the Statements on Standards for Attestation Engagements set by the American Institutes of CPAs.

Specialized Objectives

Companies may hire independent auditors to achieve specialized goals. For instance, some independent auditors specialize in risk management, where their primary goal is to determine the accuracy of a financial document, while others specialize in assurance services, where the objective is to review, confirm and improve the information the management board already has. Auditors may focus on tax matters or forensic accounting. Companies may also contract an independent audit to investigate suspicion of fraud or embezzlement.

1.3 EFFICIENCY AUDIT

Efficiency audit is much broader in its scope. The scholars express two distinct views on this subject. According to one school of thought, the principal objective of efficiency audit is to ensure that resources flow into the most remunerative channels.

1.3.1 Objectives of Efficiency Audit

1. To diagnose the operational weaknesses by a review of the organization's environment.
2. To see whether the resources of the business flow into constructive and profitable channels.
3. To assess how far the measures and techniques adopted are effective in attaining the goals and objectives of the firm.
4. To highlight the important fact in each of the functions or operations that are employed.
5. To evaluate and compare the optimum return on capital invested in the business operations.
6. To suggest and recommend feasible alternative treatments for improvements in a manner that the heads of the functional or operational management themselves would do if they have time for self — introspection (Examination of their own thoughts and feelings).

1.3.2 Parameters for Measuring Efficiency

The parameters for measuring efficiency include the following:

1. The overall rate of return on capital employed showing both efficiency of the capital turnover and efficiency of the sales.
2. Capacity utilization.

3. Utilization of natural, functional, physical, and human resources.
4. Export performance and import substitution.
5. Cash flow performance.
6. The payback period of the entire organization (i.e., by dividing the capital employed by annual cash flow).

1.4 COST AUDIT

The terminology issued by the CIMA defines Cost Audit as “the verification of the correctness of cost accounts and of the adherence to the cost accounting plan”.

ICWAI defines Statutory Cost Audit as a “system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and added information required to be maintained by the specified industries”.

Cost Audit is a critical review undertaken for the purpose of:

- (a) Verification of the correctness of cost accounts, and
- (b) Checking that Cost Accounting Plan is adhered to.

1.4.1 Meaning of Audit

- (i) The verification of Cost Accounting Records, such as Cost Accounts, Cost Reports, Cost Statements, Cost Data and Costing Techniques.
- (ii) Examining these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.
- (iii) Cost Audit is to be conducted with regard to (i) provisions of Companies Act, 1956, (ii) Cost Accounting Records Rules, (iii) Cost Accounting (Report) Rules, and (iv) Cost and Works Accountants Act, 1959.

The Companies Act, 1956 was amended by the Companies Amendment Act, 1974 introducing section 233B empowering the Central Government to order audit of cost accounts for which maintenance of Cost Accounts was prescribed in respect of companies engaged in production, processing, manufacturing or mining activities under section 209(1)(d) such particulars relating to utilization of material, labour or other items of cost as may be prescribed.

1.4.2 Objectives of Cost Audit

The objectives of Cost Audit is to ensure that in respect of companies engaged in production, processing, manufacturing or mining activities which may be specified by notification issued by the Central Government, proper records relating to utilization of material and labour are available, which would make the efficiency audit possible.

Efficiency Audit will verify and examine whether the funds invested in the business more profitably to ensure the optimum results by looking into the planning of investment and the return for every rupee of capital employed, the Cost Audit ensures Efficiency Audit through:

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- a. Determination accurate cost of jobs, materials, finished products, comparing present cost with previous experience.
- b. Making of accurate periodical financial statements for information and guidance of management.
- c. Help in determining prices of finished products by furnishing all relevant data.
- d. Determination and evaluation of production processes and find out what are profitable and what are not profitable items and determine their extent.
- e. Help in planning, operations and stock control.
- f. Determination of efficiency of operations by furnishing data as to cost, volume of production etc.
- g. Distribution of overhead costs in a rational manner.
- h. Help in continuous study and reporting as to material costs, prices, quality of material, transportation costs, plants idleness, production capacity, overhead costs etc., quality of labour, labour costs, waste, depreciation, in all its aspects such as machine deterioration, accelerated depreciation etc.
- i. Helps the management in identification and exploitation of key success factors, determination of capacity utilization, analysis of inventory policies etc.
- j. Ensures that Cost Accounting Plan is in accordance with the objectives set by the management and also in conformity with Cost Accounting System adopted.
- k. Helps in making inter-firm and intra-firm comparisons.
- l. Ensures the reliability of cost data and cost reports prepared for internal management and external agencies like Government, banks, financial institutions, statistical agencies etc.
- m. Serves as a measure to determine the managerial efficiency or otherwise.
- n. Serves as a tool to know whether resources are being properly utilized.
- o. Provides reliable data to the Government for deciding whether to offer any subsidy or extend tariff protection to any particular industry.
- p. Facilitates settlement of industrial disputes.
- q. Ensures that consumers get the product at fair price.
- r. Helps the associations of various industries to compile standard costs against which individual firms may compare their actual cost figures.
- s. Ensures to maintain Cost Accounts in accordance with the principles of costing applicable, to the industry.
- t. Helps in proper valuation of inventory.

1.5 AUDIT EVIDENCE

An audit is a systematic independent examination of financial statements, records, documents with an objective to express an opinion on the financial statements of an entity whether they are giving a true and fair view or not. Auditor expresses his opinion (whether the financial statements of an entity are giving a true and fair view or not) on the basis of audit evidence collected by him.

1.5.1 Objectives of audit Evidence

An auditor applies various audit procedure to obtain audit evidence which enables him to form an opinion whether the financial statements of an entity are free from material misstatement and state a true and fair view or not.

Audit Evidence is the information that the auditor uses in arriving at a conclusion on the basis of which he forms his opinion.

The auditor should obtain sufficient and appropriate evidence which enables the auditor to arrive at a conclusion and supports his opinion. Audit evidence forms the basis for forming an opinion whether the financial statements of an entity state true and fair view or not.

Evidence collected by the auditor should support the contents of its audit report. Sufficiency of audit evidence is the measure of the quantity of audit evidence. Appropriateness of evidence is the quality of the evidence, i.e., its relevance and reliability to support the auditor's opinion.

Audit evidence includes information provided in books of accounts as well as information from other sources. For Example – Purchase invoice and material received note prepared by the store's department are evidence to support the purchase.

1.5.2 Essential of good audit evidence

1. **Sufficient:** Sufficiency is the measure of quantity. Audit evidence is sufficient when they are available in adequate quantity. An auditor applies different audit procedures to obtain sufficient audit evidence like test checking.
2. **Reliable:** Evidence obtained by the auditor is persuasive rather than conclusive. We cannot consider such evidence 100% reliable for forming an opinion. Reliability of audit evidence depends on its source and nature of such evidence.
3. **Source:** Audit evidence obtained within the enterprise is known as the internal source. Evidence obtained from an outside enterprise like confirmation from the third party is known as the external source. We consider the external source to be more reliable.
4. **Nature:** Can be documentary (like bills, vouchers), visual (like the physical verification of fixed assets), or oral (confirmation from employees)

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- 5. **Relevant:** Whether the audit evidence obtained by the auditor is relevant or not depends on the purpose of audit procedures.

1.6 SUMMARY

- Auditing is a systematic and independent examination of data of an enterprise for a stated purpose.
- Objectives of Auditing is to verify statements to discover errors and frauds and to prevent errors and frauds
- Efficiency Audit ensure that resources flow into the most remunerative channels.
- Cost audit as the verification of the cometoness evidence means auditor express his opinion on the basis of audit evidence collected by him.
- Audit evidence means auditor express his opinion on the basis of audit evidence collected by him.

1.7 CHECK YOUR PROGRESS

1. Define an Audit, State the various objects of an audit.
.....
2. Difference between accountancy and Auditing .
.....
3. Define audit evidence and its objectives.
.....
4. Explain the essentials of good audit evidence
.....
5. Explain the scope of audit
.....

1.8 KEY WORDS

- Audit evidence :It refers to information used by the auditor in arriving at the conclusion and this term includes both information contained in the accounting record underlying the financial statements and other information.
- Auditing Techniques: This connotes different methods or means adopted by auditor to collect audit –evidence in support of transactions recorded in the books of accounts.
- Cost Audit : Cost audit is an audit process for verifying the cost of production of any article on the basis of accounts as regards utilization of materials or labour or other items of cost maintained by the company.
- Efficiency Audit: The is a means to appraise the performance of an enterprise and diagnose the weatonnes of the enterprise.

UNIT II INTERNAL CHECK

Internal Check

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2.0 INTRODUCTION

The general principles of auditing have already been discussed and now we deal with, the question of internal check which exercise propound influence on audit. The term “Internal check” implies the organization of the system of accounts of office or factory and an arrangement by which the duties of the various members of the staff of a business are allocated in such a way that the work of a business are allocated in such a way that the work done by one person is automatically checked by another, so that frauds can be committed only by collusion between two or more employees and errors or irregularities are quickly discovered. For example, the clerks in charge of the ledgers should not keep or to be allowed to make entries in the books of first entry and on no account should the cashier be allowed to have any control over the ledgers. Thus the main objective of internal check is prevent and alternatively early detection of frauds, errors, wastes and misappropriation.

Internal Check is an integral function of the internal control system. It is an arrangement of duties of the staff members in such a way that the work performed by one person is automatically and independently checked by the other.

2.1 OBJECTIVES OF INTERNAL CHECK

Following are the main objectives of Internal Check –

- To protect business from carelessness, inefficiency and fraud.
- To ensure and produce adequate and reliable accounting information.
- To keep moral pressure over staff.
- To minimize the chances of errors and frauds and to detect them easily on early stage if it is committed.
- To divide the work in such a way that no business transaction should be left unrecorded.

- To fix the responsibility of every clerk according to the division of work.

2.2 PROCEDURE FOR IMPLEMENTING ACCOUNTING CONTROL

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In this chapter, we will discuss how Internal Control works in Auditing. Internal Control system is one of the basic and essential factors for efficient and effective management. It covers the whole management system of an organization, both financial or non-financial. Internal control system is helpful for the management and also the Auditor in achieving goals and targets effectively. Therefore, internal control system covers a number of checks and control to ensure efficient and economic working.

There are two types of controls — Financial Control and Administrative Control. Reliability of financial records and safeguarding of assets is a part of financial control. We will now understand in detail what Internal Control System.

Internal Control

Internal Control comprises of the plan of the organization and all the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data to promote operational efficiency and to encourage adherence to prescribed managerial policies.

2.2.1 Purpose of Internal Control

Let us now understand the purpose of Internal Control from different points of view.

From Auditor's Point of View

It is very important from the Auditor's point of view to study and evaluate the system of internal control. To obtain an adequate understanding of the internal control system, that must be tested. The Auditor has to determine whether audit is possible, if yes, then he should determine the scope of audit.

From Client's Point of View

- Internal control system provides reliable and accurate data that is necessary for decision making and to run business activity efficiently.
- Adequate internal control system safeguard business assets, in absence of it, assets of the company may be stolen, misused or accidentally destroyed.
- Internal control system within organization is necessary to discourage and stop non performing business activities and to protect business from wastage is all aspects of the business.
- Internal control system insures that rules and procedures are to be followed by business personnel.

2.2.2 Characteristics of Internal Control

Following are the main characteristics of Internal Control usually abbreviated as CROSSASIA –

- Competent and trustworthy personnel
- Records, Financial and other Organization plan
- Organizational plans
- Segregation of duties
- Supervision
- Authorization
- Sound practice
- Internal Audit
- Arithmetic and accounting controls

2.2.3 Limitations of Internal Control

Following are the inherent limitations of Internal Control –

- Management decision to choose cost effective control system may reduce the effectiveness of internal control system.
- There are chances of misuse by a person of authority who is operating on internal control system.
- Objectives of internal control systems may be defeated by manipulation of management.
- Since internal control system is involved in routine transactions, irregular transactions may be overlooked.
- Changes in conditions may affect the effectiveness of internal control system.

2.2.4 Scope of Internal Control

Following are the main areas which are generally covered by a good internal control system –

- **Cash** – Here, internal control is applied over payments and receipts of an organization. This is to safeguard from misappropriation of cash.
- **Control over Sale and Purchase** – With proper and efficient control system for transactions regarding purchase and sale of material, handling of material and accounting for the same is must.
- **Financial Control** – It deals with the efficient system of accounting, recording and supervision.
- **Employee's Remuneration** – Internal control system is applied to preparation and maintenance of records of employees and the payment methods also. It is also necessary to safeguard against misappropriation of cash.

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- **Capital Expenditure** – Internal control system ensures the proper sanction of capital expenditure and also the use of it for the purpose intended.
- **Inventory Control** – It covers the proper handling of inventory, minimization of slow moving items or dead stock, proper valuation of stock, recording of it, etc.
- **Control over Investments** – internal control system is applied to the proper recording of transactions be it purchases, additions, sale or redemption, income on investments, profit or loss on investment.

Internal Control and Auditor

- An Auditor should ensure that certain rules and procedures are followed by the business unit he is working on, in spite of the fact that a sound system of internal control is as sole responsibility of the management. The Auditor can simply guide or help the management if he is asked to do so, because he has no authority to prescribe such rules and procedures. The degree of reliance on the system depends upon the effectiveness of internal control system; therefore, the Auditor should review and evaluate the internal control system of an organization to prepare his audit Program.

Review of Internal Control System

Internal control system should be reviewed by the Auditor before star audit as described below –

- Reviewing the system of accounting entries, whether recorded as per accounting standard or not.
- To frame audit program according to present circumstances.
- Frauds, errors and mistakes are likely to be located or not.
- To review existence of internal audit program and to check the efficiency of internal control system.
- To review the reliability of reports, records and certificates as presented by the management.
- To check if there is any possibility of improvement in existing internal control system.

2.3 COMPARISON OF INTERNAL AUDIT AND INDEPENDENT FINANCIAL AUDIT

Points	internal audit	External audit
Objective	Main focus of internal audit is to ensure adherence to policies and procedures and economic and effective utilization of resources	Main objective of external audit is to ensure whether financial statement reflects true and fair view of the business enterprises

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Qualification	Internal auditor need not be a qualified auditor under section - 226 of the Companies Act 1956	He should be a qualified chartered accountant
Appointment	He is appointed by management	He is appointed by the shareholders
Nature of function	He is functioning as a staff specialist	He is functioning as a line officer
Scope of work	He is determined by the management	It is determined by the Statute
Compulsion	It is optional	It is mandatory for the corporate bodies.
Reporting pattern	He has to report to the management	He has to submit his report in a prescribed format to the shareholders at the Annual General Meeting
Powers and duties	It is determined by the management. It is subject to the limit prescribed by the management	Powers and duties are determined by company Act.
Liability	He is liable to management. he is not liable to third parties	He is liable to the shareholders and third parties. Civil and criminal liabilities and be cast on him
Removal	He can be removed at the will and pleasure of management	He can be removed by the shareholders
Right to attend annual general meeting	He has no such power to attend the meeting	He can attend the meeting and speak at the meeting to defend his action
Tenure	it is a continuous audit and conducted throughout the year	It is conducted after the closure of books of accounts
Suggestions and recommendations	He studies the efficacy of various control mechanisms and makes recommendation to tone up the operational efficiency	He audits the accounts to ensure the reliability of financial statements.

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2.3.1 Operational audit

It is a systematic independent appraisal activity with an organization for a review of the entire departmental operations as a service to management.

2.4 CHECK YOUR PROGRESS

1. Define Internal control.
.....
2. What is mean by internal check?
.....
3. Explain the limitation of internal control .
.....
4. State the difference between internal audit and independent financial Audit.
.....
5. Define operational audit.
.....

2.5 KEY WORDS

- Internal audit : It refers to a continuous audit by employees of an entity who critically review the financial activities of a concern.
- Internal Control: It refers to the whole system of control financial on otherwise established by the management to safe guard its assets and to secure the accuracy and reliability of records.
- Internal Check: this is a system of distribution of work in such a way that the work of are employee is independently checked by an other member of the staff
- Operational Audit: It is a systematic independent appraisal activity a within an organization for a review of the entire departmental operations as a service to management.

2.6 SUMMARY

Internal check is an integral function of the internal control system. It is an arrangement of duties of the staff members in such a way that the work performed by one person is automatically and independently checked by the other.

UNIT III VOUCHING

Vouching

- 3.0 Introduction
- 3.1 Objective of Vouching
- 3.2 Voucher
 - 3.2.1 Importance of Vouching
 - 3.2.2 Types of Voucher
- 3.3 Vouching of Cash Book
 - 3.3.1 Vouching of Cash Receipts (Debit Side of Cash Book)
 - 3.3.2 Vouching of Cash Payments (Credit Side of Cash Book)
- 3.4 Auditing - Vouching of Ledger
 - 3.4.1 Personal Ledger Accounts
 - 3.4.2 Impersonal Ledger Accounts
- 3.5 Documentary Evidence
- 3.6 Window dressing
- 3.7 Summary
- 3.8 Key words

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3.0 INTRODUCTION

Accounting entries made in the books must be supported by documentary evidence and inspection of that evidence is called vouching. The Auditor judges the authenticity, of the accounting entries using the technique of vouching. In case of unavailability of proper supporting documents, the Auditor may have all reasons to doubt about errors or fraud or manipulation.

Thus, auditing is incomplete without vouching.

In auditing process, based on evidence, there are two main functions

- Collection of evidences – through observation, confirmation, inspection, inquiry.
- Evaluation of evidences – with relevance, adequacy and validity.

3.1 OBJECTIVE OF VOUCHING

Following are the main objectives of vouching –

- To check whether all the business transactions are properly recorded in the books of accounts or not.
- To see whether recorded transactions are duly supported by documentary evidence or not.
- To verify that all the documentary evidence is authenticated and related to business transactions only.
- To verify that transactions are free from errors or frauds.
- To verify whether voucher is processed through all the stages of Internal Check system properly.
- To verify and confirm that the entries are recorded according to the capital and the revenue nature or not.

- To check the accuracy of accounting transactions.

3.2 VOUCHER

A Voucher may be a sales bill, purchase bill, payment receipt, pay-in slip, etc. all such types of documentary evidence are known as voucher.

3.2.1 Importance of Vouching

Vouching forms the base for auditing and has an important part of Auditor's duty. In case of negligence in vouching, the Auditor will be held responsible; he cannot escape from his duty, if he has done vouching carelessly. Following points show the importance of vouching Vouching is equally important as passing of original entry in the books of accounts. If, original entry is wrong, it will affect every process of accounting entry and its impact will be till the end result. Similarly, vouching is base of all auditing process.

- Efficiency of vouching will decide the success of audit.
- Any errors and frauds are easily detectable if vouching is conducting in searching and intelligent manner.
- Intelligent and faithful vouching will establish reliability on financial statements, i.e., Profit and Loss account and Balance Sheet of any organization.
- If adequate internal control system exists, the Auditor may choose to do test checking instead of complete vouching.

3.2.2 Types of Voucher

There are two types of vouchers –

- **Primary Voucher** – Original copy of written supporting document is called primary voucher. Like purchase Bill, cash memo, pay-in-slip, etc.
- **Collateral Voucher** – Copies of supporting documents which are not available in original are collateral voucher like duplicate or carbon copy of sale invoice.

3.3 VOUCHING OF CASH BOOK

3.3.1 Vouching of Cash Receipts (Debit Side of Cash Book)

We will discuss the cash receipt which are placed on the debit side of cash book for following items –

Opening Balance of Cash Book

Opening balance of cash book represents cash in hand at the start of the year and should verified from the balance sheet of last financial year.

Cash Received from Debtors

Consider the following points for verification of cash received from debtors –

- The carbon copies or counterfoils of cash receipt book should be verified.

- Cash receipt should be serially numbered.
- Cash received should be entered on the same date when the cash is actually received.
- The discount allowed to customers should be properly authorized by a responsible officer.
- Correspondence with customer and ledger account should be tallied.

Following are the different ways used for misappropriation of cash –

- Cash received from customer not recorded in books and no cash receipt may be issued.
- Issuance of receipt for lesser amounts than amount actually received.
- Using teeming and lading method; it is a very common method to misappropriate the money, in which the cash received from any customer not recorded in the books and the cash received from same customer at a later instance or another customer recorded in the books and so on.

Repayment of Loan by Others

Repayment of loan by others may be verified in the following ways –

- Calculation of interest received and interest should be credited to interest received account.
- Verification from bank statement if directly deposited by party into bank.
- Checking of carbon copies or counterfoils of cash receipts.
- To ensure that there should be no violation of Income Tax rules as payment of loan exceeding Rs. 20,000/- cannot be repaid in cash. It should be through Cheques, Demand Draft, NEFT, RTGS or any other available banking channels.

Rent Received

- To check rental agreement or lease deed.
- In case where the rental income is received from more than one property, separate account for each property should be maintained.
- The Auditor should verify that the rent for all the twelve month is received or not.
- The amount of rent should be verified from the rent deed or the lease deed.
- If TDS (Tax Deducted at Source) is deducted by the party, there should be proper accounting of TDS.

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Sale of Investments

- To check bank statement if the sales proceeds have reached the bank account.
- To verify broker commission, note or debit note, if investments are sold through broker.
- To ensure separate accounting is being done for capital receipts and revenue receipts. Dividend or profit or loss on sale of investment is a revenue receipt and the sales proceeds of the investment cost should be booked as capital receipt.

Subscription

Subscriptions are received from the members of a club and the following points need to be considered by the Auditor while vouching subscription –

- Subscription register should be verified.
- Verification of subscription received during the year and the subscription receivable.
- Counterfoil of cash receipt should be verified.

Sale of Fixed Assets

- To check minutes of the meetings of the Board of Directors.
- Sale agreement or sale contract.
- Verification of agent account if sale is made through an agent.
- Profit or Loss on sale of fixed assets should be booked to revenue account.
- Authorization of sale of fixed assets.
- Sale proceed of fixed assets should be credited to fixed assets account after deducting expenses on sale of fixed assets if any.

Interest and Dividend Received

- Verification of the dividend warrant letter along with the covering letter for verification of dividends in case of dividends received through cheque.
- Verification of bank statement, if the dividend is directly credited to the bank account.
- Interest on security can be vouched from the securities schedule.
- Interest on fixed deposit can be verified from bank statement and TDS certificates.
- Interest received from outsiders to whom company has granted loan could be verified from statement of account of party along with TDS certificates.
- Provision should be made for interest accrued but not due.
- All interest received and accrued should be properly accounted for in the books of accounts.

Commission Received

- Verification of agreement on the basis of which the commission is received.
- Calculation of the commission receivable.
- The commission received should be verified from counterfoils, bank statements, cash receipts, etc. and the provision for commission receivable should be rightly accounted for in the books of accounts.
- Commission receivable on “sale of goods sent on consignment” should be verified from sale account.

Installments Received on Hire-Purchase Sale

- Study of the Hire-Purchase agreement for hire-purchase-sale price, number of installment, rate of interest etc.
- Segregation of principle amount and interest amount should be done and both should separately account for.
- Profit on sale on hire-purchase should be duly calculated on the basis of installment received during the year.

3.3.2 Vouching of Cash Payments (Credit Side of Cash Book)

All the payment made to creditors, expenses incurred in cash and all other payments done appear on the credit side of cash book and the Auditor is required to vouch cash payments because chances of cash misappropriation are very high.

Following points need to be considered for different types of cash payment –

Opening Balance

The opening balance of cash book can never be credited because cash of company cannot be in negative but the credit bank balance represents the overdraft account from bank or utilization of cash credit limit as sanctioned from bank.

Payment to Creditors

Payment to creditors may be examined by the following –

- Receipt issued by the creditors.
- If the creditor is paid amount as full and final settlement, the balance amount, if any stands in the ledger account of the creditor; this amount should be credited to discount received.
- If any advance payment is made to creditor that should be clearly mention.
- Statement of account of creditor.

Vouching

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Payment of Salaries

Depending upon the adequacy of internal control system in an organization Auditor will decide his audit Program. It is very important for Auditor to check the following –

- Attendance record of employee and salary register.
- Appointment letter of new employees.
- Comparison of current month salary with last month's salary and if there is any abnormal change in amount, Auditor should verify the same.
- Alteration in amount of deductions on account of advance, loan, fine, funds, insurance, TDS, etc.

Payment of Wages

At the time of vouching of wages paid, the Auditor should verify the following points to avoid misappropriation of cash –

- Adequacy of Internal Control System.
- Payment of wages at higher rate than allowed.
- Payment shown to ex-workers in the current month.
- Lower or non-deduction of advance or other deductions due.
- Payment to fictitious workers.
- Payment to workers who were absent from duty.
- Wages sheet should compare with wages register.
- Comparison of current month wages with last month's wages and proper verification should be there for extra ordinary changes.
- Detailed verification for payment to casual workers.
- Vouching and verification of treatment accounting treatment for unpaid wages.

Purchase of Plant and Machinery

The Auditor should pay attention to the following –

- Purchase invoice of machinery.
- Freight inward charges, installation charges, erection and commissioning charges should be capitalized.
- Treatment of Excise duty according to the excise rules.

Purchase of Land & Building

Purchase of Land and Building can be vouched as follows –

- Study of Lease hold agreement, if land is purchased on lease hold basis.
- Payment should be as per lease term.
- All the expenses incurred to acquire lease hold property should be debited to respective property account.

- Auditor should study the conveyance deeds in case property is purchased under free hold basis.
- For verification of payment, the Auditor can check the payment receipt and the conveyance deed.

Rent Paid

Consider the following points for the verification of rent by the auditor –

- Rent Deed.
- Rent receipt from Land lord.
- Provision for un-paid rent at the end of the year.

Insurance Premium

Consider the following points for the verification of Insurance Premium

- Insurance policy issued by the Insurance Company.
- Insurance premium receipt
- Insurance premium should not be related to any official of the company.

Income Tax

Consider the following for the verification of Income –

- Advance Tax Challan
- Self-Assessment Tax challan
- Income Tax demand notice
- Assessment order

Excise Duty

Consider the following for the verification of Excise Duty –

- Rate of Excise Duty
- Excise records and sale invoice for verification of excise duty

Commission on Sale

Consider the following for the verification of Commission on Sale –

- Agreement of sale.
- Rate of commission on sale.
- Calculation of commission on the basis of sale.
- Cash receipt issued by agent.
- Provision for commission payable

Director's Fees

Consider the following for the verification of Director's Fees –

- Directors receive fees for attending the Board meetings.
- Verification of attendance register.

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- Verification of payment receipt duly acknowledged by the directors.
- Provision for commission payable

Director's Fees

Consider the following for the verification of Director's Fees –

- Directors receive fees for attending the Board meetings.
- Verification of attendance register.
- Verification of payment receipt duly acknowledged by the directors.

Internal Control System for Cash Transactions

Following are the main features of a good internal control system –

- All cash received should be accounted for immediately.
- All received cheques should be crossed immediately on receipt.
- Cash receipt should be issued to debtors and daily reconciliation of account should be done where the debtors pay cash on daily basis.
- All cash receipts should be deposited in bank on a daily basis.
- Bank reconciliation account should be prepared on a regular basis.
- Payments other than petty payments should be done through crossed cheques.
- Cash receipt should be obtained for every cash payment to creditors.
- Cash expenses should be duly supported by proper and genuine bills or vouchers.

3.4 AUDITING - VOUCHING OF LEDGER

We will start by discussing the types of ledger accounts and proceed to their verification and also the verification of other accounts.

3.4.1 Personal Ledger Accounts

All personal accounts are opened under this category. In big organizations where the number of transactions is quite high, a personal ledger may further be split up into two more ledgers –

- Purchase ledger
- Sales ledger

Purchase ledger

Purchase ledger is verified from the following –

- Creditor balances of last year
- Cash Book and Bank Book
- Purchase register

- Purchase return book
- Bills payable book
- Journal and other relevant books

Vouching

An Auditor should carefully verify the following –

- Posting of all vouchers in ledger account should be done without any omission.
- Verification of all opening balances should be properly checked with last year's balance sheet.
- If the creditor balance shows debit balance it may be due to advance payment made to him, the Auditor should confirm whether the material against advance is received or not.
- Periodical statements of creditor should be reconciled.
- Examination of internal control system.

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Sales ledger

Sales ledger will be verified from the following –

- Debtors' balances of last year
- Cash book and bank book
- Sales register
- Sales return book
- Bills Receivable book
- Journal and other relevant books

Auditor should carefully verify the following –

- Posting of all vouchers in ledger account from cash and bank book, sales register, bills receivable register, sales return register and journal should be verified.
- Verification of opening balances, castings, balances carried forward should be carefully examined.
- Credit balance of the debtors' account may represent the advance received against the supply of goods; the Auditor should examine and confirm whether any material is supplied against it or not.
- Periodical reconciliation of account from debtors should be done without any fail.
- Provision for doubtful debts and bad debts should be done.
- Review and examination of credit policy should be made from time to time.
- Checking of posting in ledger account from subsidiary book.
- Checking of calculations.
- Reviewing truthfulness of debtor balances in customer account.

- Reviewing of Internal Control System.

3.4.2 Impersonal Ledger Accounts

All the nominal account, real account and capital account fall under impersonal ledger accounts. Income and expenditure account (nominal accounts) transferred to profit and loss account.

Capital account, real accounts, debtors and creditors account are transferred to balance sheet. Following steps are involved in the audit of impersonal ledger account –

- Opening balances should be verified from last year's Balance Sheet.
- Timely posting of balances of subsidiary books (Sales Book, Purchase Book, Sales Return Book, Purchase Return Book) to ledger accounts.
- Checking of totals and castings.
- Checking of balances transferred to trial balances, debit and credit side of trial balance should be tallied.
- Checking of adequacy of internal control system in organization.

Outstanding Assets

It is necessary to include some expenses and income in current year though passing adjustment entries to show the correct profit or loss of the company. Therefore it is must for an Auditor to check each and every outstanding entries. Following are outstanding assets –

Prepaid Expenses

These expenses are paid in advance for next coming year(s), hence should not be debited to profit and loss account of current year to arrive at true financial results.

For example; Insurance of Fixed assets is normally paid on annual basis and if we paid insurance premium in the month of October for one year, then insurance for this current year will be calculated from October to March and from April to September it will be treated as prepaid insurance. Prepaid insurance will be shown as prepaid expenses under the head of current assets in the balance sheet.

Auditor should vouch every nominal account to confirm whether correct amount of expenses is debited to profit and loss account or not. Other examples of prepaid expenses are –

- Rent Rates and Taxes
- Subscription
- Annual maintenance Contract, etc

Income Receivable

Following are the examples of Income Receivable –

- Interest accrued but not due or received
- Taxation claims

- Commission
- Declared dividend by company yet to receive

All the above income should be included in the Profit & Loss account of the year to arrive at a correct figure.

Deferred Revenue Expenditure

The examples of deferred revenue expenditure have been described below –

Preliminary Expenditure

Preliminary expenditure is incurred at the time of incorporation of a new company. These expenses are of heavy amount and are incurred mainly for promotional reasons. Nature of these expenses are capital but not actually represent any asset, hence should be written off from profit and loss account over a period of 3 to 10 years in equal installments.

Advertising and Sales Promotion

These expenses are incurred at the time of establishing new business or at the time of introduction of any new product in the market. These expenses are shown as assets in Balance sheet and should be written off in profit and Loss account over a numbers of accounting periods.

Heavy Repairs

Expenses of heavy repairs of fixed assets shall not be debited to profit and loss account of year in which these expenses incurred but it should be spread to number of years like other deferred revenue expenses. Heavy amount of expenses is incurred on repair of Plant & Machinery due to increased production capacity of the plant or to maintain current production capacity of machine which is very old and need some heavy overhauling or repairing to increase it life.

Other examples of deferred revenue expenses are –

- Discount allowed on debentures
- Experimental expenditure
- Research & development expenses
- Development expenses on mines

Outstanding Liabilities

There are some expenses and liabilities that come up in due course of business; these are due for payment but not paid till the end of accounting period in question. The Auditor should see all those expenses and liabilities and all these expenses should be included in profit and loss of the current year to arrive at the true profit or loss of the firm.

Following are the main examples of outstanding expenses and liabilities

Vouching

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Audit Fees

Audit fees are debited to profit and loss account of the same year for which audit is conducted. No doubt main audit work start after the close of financial year and finalization of financial statements are done in next financial year but it is a widely accepted practice to do so. It is also argued that audit fee should be debited to the profit and loss account in the next year in which the audit work is actually performed. In the first case, audit fees will be debited and the audit fees payable will be credited.

Purchases

In case where the purchased goods are received in the current financial year and invoices for the same are received in next year, purchase should be debited and outstanding liabilities should be credited.

Rent

Rent on factory premises, office building, godown, etc. is payable on monthly basis. The Auditor should confirm that any unpaid amount of rent for the last month of the financial year or any other month of financial year in question should be added to rent of the current year and the rent payable should be shown as current liabilities.

Commission on Sale

Commission on sale is payable to agent, director or salesmen on the basis of sales. Auditor should check the following –

- Sale agreement
- Rate of commission
- Calculation of commission
- Agent account to know advance payment to agent, commission due and commission payable.
- Applicability of TDS on it and to check whether TDS is deducted at due rate before making payment or not. Whether TDS is deposited in time or not.
- After adjusting all the above, if there is any amount that is payable to the agent, it will be shown in current liabilities as commission payable and if any excess amount is paid that will be shown as current asset representing the amount recoverable from the agent.

Interest

The Auditor should carefully examine the interest on loan from bank, loan from outsider parties, unsecured loan, financial institutions, term loan and interest on debentures. He should see that the provision for interest payable should be duly provided in the books of accounts according to the applicable rate of interest.

Salary and wages

Salary and wages for the last month of the accounting year is normally paid in the next financial year. The Auditor should confirm that the salary and wages for last month should be debited to salary and wages account and credited to salary & wages payable account.

Cartage and Freight

Transporters normally provide bills for transportation charges after closing of financial year. It is a duty of an Auditor to take these expenses in the current financial year creating liabilities for the same.

Contingent Liabilities

Contingent liability may be payable in future or may not be payable in future it depends on the event. For example, if any person filed a suit against company, possibilities are there, it may be in favor of company or it may be against the company, in case it will decide against the company, company has to pay such amount of suit as the court decides. Therefore, contingent liabilities are said to be possible liabilities.

In case of above, no actual provision is made in the books of account but as a footnote of Balance sheet, it is compulsory to show the probable amount of liabilities.

Contingent Assets

Contingent assets are not shown as footnote of the balance sheet. Following are the examples of Contingent Assets –

- Claim for the refund of the Income Tax, Sales Tax, Excise Duty, etc.
- Uncalled share capital of the company.
- Claim for infringement of a copy right.

3.5 DOCUMENTARY EVIDENCE

- Includes invoices, supplier's statements, bank statements, minutes of meetings, correspondence, and legal agreements. Can be internally or externally generated. Ways that documentary evidence can be used:
- Vouching - verify information in clients records by reading documents to confirm existence, rights and obligations
- Tracing - trace from documents to clients records to confirm classification, accuracy and completeness

3.6 WINDOW DRESSING

Is a manipulation or miss-representation of financial data in such a way that it seems better than what it actually is. Some of the method of window dressing is given as hereunder.

- Over valuation of closing stock
- Under valuation of Liabilities or Over-valuation of assets

Vouching

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Secret reserves of previous years may be used in the current financial year to inflate the profit or secret reserves may be created to suppress the profit of the current financial year.

Stock may be under or overvalued. Income and sales may be suppressed or inflated. Expenses and purchases may be suppressed or inflated.

3.7 CHECK YOUR PROGRESS

1. Define vouching and explain its objects.
.....
2. What is the distinction between goods sold on assignment basis and on sale or return basis.
.....
3. Why should the auditor be concerned with purchase returns?
.....
4. What are the documents to be examined while vouching purchases.
.....
5. What is a voucher? What consideration or points should auditor keep in mind while examining a voucher?
.....
6. Discuss the procedure for vouching the items appearing on the debit side and credit side of cash book.
.....
7. How will you vouch the Bought ledger and sales ledger of a manufacturing concern?
.....

3.8 SUMMARY

Vouching is “the examination of 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”.

The main objects of vouching may be stated as follows

1. All transactions connected with the business have been properly recorded in the books of account.
2. The entries in the books of account pertain to transactions which are genuinely connected with the business.
3. The vouchers have been carefully processed through cash stage of an effective system of internal check.
4. The vouchers have been properly authorized.

Vouching is considered to be the essence of auditing or backbone of auditing due to the following reasons.

Primary step in auditing Vouching is the preliminary step in the audit of accounts. If an auditor completes this work carefully, he can proceed further in his task easily.

Accuracy of books of accounts: The main aim of audit is to check the books of accounts to ascertain their accuracy. This object of audit is fulfilled by vouching since it establishes the accuracy and authenticity of transactions.

Basis for the verification of assets and liabilities :Vouching is the basis of verification of assets and liabilities which is the next step in auditing. The auditor has to certify the correctness of assets and liabilities appearing in the Balance sheet for which vouching is helpful to him. Let us take an example of cash at bank stated in a Balance Sheet. If it is to be certified as correct, hit auditor has to vouch the pass book, counterfoils of the paying in slips, banker's advice note, counterfoils of cheque book and other correspondence with the bank

He should further compare these items with the cash book and check the bank reconciliation statement

3.9 KEY WORDS

- Voucher: It is a documentary evidence in support of entries in the books of accounts.
- Vouching : It is defined as examination of the evidence offend in substation of entire in the books of accounts.
- Teaching and leading: Teaching and lading a method adopted to temporally misappropriate cash. Misappropriation is activated by making a false entry relating t a transaction which in turn is cancelled by a further entry and so on until such fraud is discovered.
- Window dressing: It is defined as on artificial practice to show that the current financial position is favorable by manipulation of accounts.

Vouching

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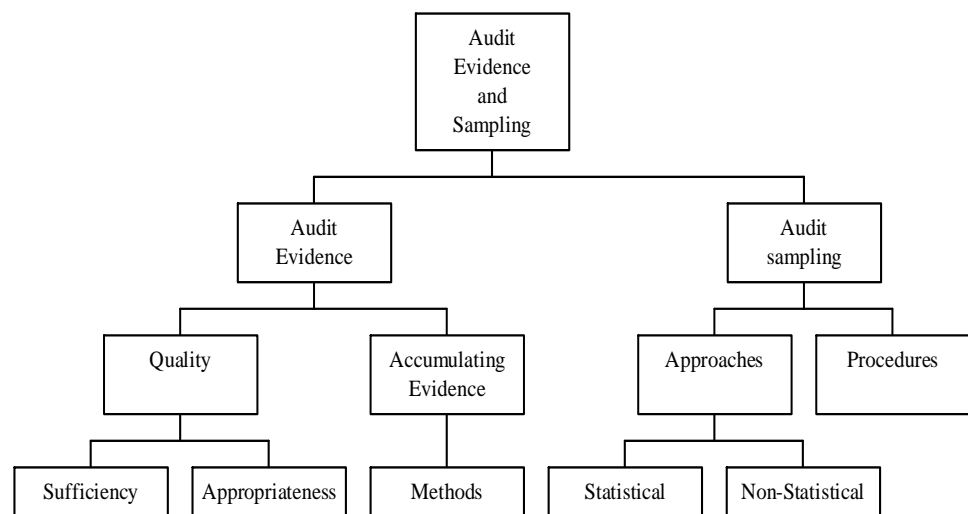
UNIT IV AUDIT SAMPLING AND EVIDENCE

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- 4.0 Introduction
- 4.1 Objectives
- 4.2 Audit evidence
 - 4.2.1 Evidence to be compatible with the objective of Audit
 - 4.2.2 Nature of evidence
 - 4.2.3 Procedures
- 4.3 Audit Sampling
 - 4.3.1 Statistical Sampling
 - 4.3.2 Advantages of Statistical Sampling
 - 4.3.3 Limitation of statistical sampling
- 4.4 Test Checking
 - 4.4.1 Precautions of auditor while applying test checking
 - 4.4.2 Advantages of Test Checking
- 4.5 Self Assessments Questions
- 4.6 Summary
- 4.7 Key words

4.0 INTRODUCTION

Auditor has to base his opinion on financial information and draw conclusion based there on hence he should gather evidence and test them before expressing any opinion on financial statements. According to AASI dealing with principles of audit an auditor should obtain sufficient and appropriate audit evidence through the test of compliance and substantive precedence.



4.1 OBJECTIVES

- Highlights all aspects relating to collection and evaluation of audit evidence.

4.2 AUDIT EVIDENCE

It refers to information used by the auditor in arriving at the conclusion and this term includes both information contained in the accounting records underlying the financial statements and other information.

Auditor has to gather relevant adequate and useful evidence during the course of the audit work.

4.2.1 Nature of evidence

The evidence may be oral, written, physical existence, system analytical tools, etc. Written evidence may exist in the form of books of account, ledger, confirmation, written replies and so on. The verbal evidence may be acquired by replies from staff concerned, telephonic contracts, meeting the person concerned, and so on. Physical evidence can be collected in respect of tangible assets like factory building, investments, etc. Certain fixed assets like concealed electrical fittings cannot be inspected physically. Burning bulbs evidence the soundness of concealed fittings. Thus circumstantial evidence confirms the presence of such assets. Besides events taking place after the balance sheet may provide certain evidence. For example, bankruptcy of debtors signifies recoverability of duties of the companies. Which evidence is best for a given assertion cannot be precisely stated. It is a matter depending on the nature of the transactions amount involved. etc.,

Accounting system produces various data relating to transactions. These data convey the following assertions in financial statement.

1. Existence: The very existence of an asset/liability i.e. said assets physically exist.
2. Rights and obligations: The rights of enterprise over assets and the obligations of enterprises towards various parties.
3. Occurrence: The happening of a transaction during a given period.
4. Completeness: All transactions taking place in a given period should find a place in financial statements without omission.
5. Correctness : Rightness of the monetary values of asset/liability.
6. Measurement : Accurate recording of transactions e.g proper allocation of capital and revenues expenditure.
7. Disclosure : Disclosure of data as per accounting conventions and statutory requirements.

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4.2.2 Procedures

Financial statements expose these assertions. Auditor has to ensure that the these assertions are fairly represented in the financial statement. Hence he has carry out substantive procedure.

Evidence to be compatible with the objective of Audit

The evidence gathered should enable him to accomplish the audit objective. Each and every audit assignment has a distinct objective. Hence he has to consider the nature of company's economic activity, accounting practices in place in client's organization and assertions embodied in financial statements to take concrete decision in this regard.

Evidence to be Relevant to the proposition

An auditor should have a thorough knowledge of proposition to be proved professor mates and shad view that there are five different categories of proposition contained in the accounting data. They include

- Assertions of existence or non-existence
- Assertions of past events
- Assertions of quantitative conditions.
- Assertions of quantitative conditions
- Assertions of a mathematical nature.

Internal Consistency of Accounting Records

A auditor should ensure the consistency of accounting data by applying certain tests like analytical review, recalculation of figures arrived, retracing procedural steps in the accounting process and reconciliation of related information.

Testing Supportive as well as Corroborative Evidence

Mere testing the underlying accounting data will not suffice to draw evidence for the cost and financial statements. esides some more tests are required to confirm adequacy and relevance of evidence obtained.

- Physical examination of assets.
- Inspeótion of documents like cheques. invoices, contracts, minutes of meeting and the like.
- Observation of employees across the hierarchies and physical conditions within the company.
- Obtaining confirmation of balaikes from the customers, suppliers and other persons.
- Gathering information by inquiry, observation, inspection, physical examination or valid reasoning.

Preparing Working Papers

Gathering evidence is one of the field works done by the auditor. He records the evidence gathered during the course of audit assignment and conclusions arrived in terms of evidence collected. Working papers serve as proof that the auditor has duly pursued the field work prescribed as per auditing standards.

4.3 AUDIT SAMPLING

Statistical sampling refers to an approach to sampling that has the following characteristics –

- Random selection of sample items, and
- The use of probability theory to evaluate sample results, including measurement of sampling risk.

4.3.1 Statistical Sampling

Sampling without the above characteristics is to be considered as a non-statistical approach. Whatever may be the sampling approach, the sample must be similar to the larger data it represents? Non-statistical sampling is neither scientific nor objective. Reliability of audit objectives can be measured in statistical sampling.

4.3.2 Advantages of Statistical Sampling

Following are the advantages of Statistical Sampling –

- Increase in the size of population does not mean increase in sample size.
- Indication of specific risk and precision are associated with estimation of minimum sample size.
- This technique is free from any association of human bias.
- With minimum efforts, cost and time, it provides maximum information.
- Sample represents the whole population.
- For verification of work-in-progress and inventory, it is a very useful technique because total errors can be predicted on the basis of errors in the sample.

4.4 LIMITATION OF STATISTICAL SAMPLING

Following are the limitations of statistical sampling –

- Without effective and adequate internal control system, this technique cannot work properly.
- Without adequate size and sample, result of it can be misleading.
- This technique requires more time and energy which is not practical in certain situations.

Prerequisites of Statistical Sampling

Following are the prerequisites of Statistical Sampling –

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- Every item in population has equal chance of selection for sampling and each selected item for sample is of equal importance.
- There must be an appropriate size of sample to enable the Auditor to form an opinion about the genuinity of financial statements.
- Sample should be representative of the whole population

4.5 TEST CHECKING

Test checking in Audit means checking a few transactions selected at random from a large number of transactions. It is also known as “*Selective Verification*” or “*Sampling Process*”.

It is a substitute for detailed checking. It involves only a partial checking. It is based on a simple theme that

If a representative number of transactions, randomly selected by the auditor for test checking is found to be correct, the rest might be correct too.

In simple words in test checking a representative number of entries of each class is selected and checked and, if they are found correct, the remaining entries are also taken to be correct. Test checking is an accepted substitute of detailed checking, which in most of the cases from the economic point of view is unwarranted.

4.5.1 Precautions of auditor while applying test checking

While applying test checks the auditor should take the following precautions:

1. As far as possible sample transactions should be selected from every book.
2. The selection of transactions should be so distributed that the work of almost all the clerks of the client is checked.
3. The items should be selected at random.
4. As fraudulent manipulations are common during the first and last months of the period under audit, the entries made during these periods should be checked thoroughly.
6. In the selection of entries and accounts for applying test checks, care should be taken to check the different portions of the work at each audit.
7. Cash book and pass book should be checked thoroughly.
8. The auditor should select the transactions on his own. He should not consult the staff of the client while selecting the transactions.

If the auditor exercises the above safeguards with care and caution, the results are bound to be encouraging and satisfactory.

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4.5.2 Advantages of Test Checking

Test checking enjoys the following advantages:

1. It saves time and energy.
2. If the selection of transactions is done intelligently, test checking is useful and purposeful.
3. The volume of work is reduced. So the auditor can carry on many audit simultaneously.
4. It helps the auditor to arrive at a definite conclusion in regard to the true and fair view of the state of affairs of the concern.
5. It helps in reducing the cost of audit.

Disadvantages of Test Checking

Test checking suffers from the following disadvantages:

6. It is not possible to detect all the errors and fraud.
7. The clerks of the client may become careless because they know that their work will not be checked in detail.
8. Under test checking, although the auditor checks the whole of the work through test checking, suspicion and doubt will remain in his mind.
9. It is of no use if proper and effective systems of internal checks and controls are not being adopted in business.
10. It is not suitable for small business concerns.

4.6 CHECK YOUR PROGRESS

1. Define audit evidence and its nature
.....
2. Explain the procedure in audit evidence
.....
3. Explain the methods of audit sampling
.....
4. Explain the advantages and disadvantages of test checking
.....
5. Explain the precautions of an auditor while applying test check
.....

4.7 SUMMARY

The decision to adopt testing methods depends entirely on the auditor's judgement and discretion depending on the individual cases and circumstances.

Test checking should be applied and carried out intelligently and carefully; otherwise, it may lead to dangerous consequences. However, the use of test checking depends much upon the system of internal check in operation and the intelligence of the auditor.

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4.7 KEY WORDS

Test checking: It is a process of choosing a few items of the representative nature and checking them thoroughly in stead of checking all the transactions.

Statistical sampling: statistical sampling refers to an approach to random selection of sample items and there of probability they to evaluate sample result, including measurement of sampling risk.

BLOCK II AUDIT OF LEDGER VERIFICATION AND COMPANY AUDIT

Audit of Ledger

UNIT V AUDIT OF LEDGER

NOTES

- 5.0 Verification of General Ledger
- 5.1 Objectives
- 5.2 Role of auditor
- 5.3 Derivatives
- 5.4 Summary
- 5.5 Self Assessment
- 5.6 Key words

5.0 VERIFICATION OF GENERAL LEDGER

The cash book, purchase book, sales book, sales return book, Purchase returns book are to be totaled periodically and the summary is posted in the general ledger.

The ledger accounts are also adjusted according to the Standard Accounting Principles and as per the legal requirements applicable to the specific concern. These adjustments are done through general ledger.

The ledger balances are classified and grouped and ultimately included in the profit and loss account and Balance Sheet.

5.1 OBJECTIVES

- Is to ensure the accuracy of leader accounts.

5.2 ROLE OF AUDITOR

Therefore, the auditor should scrutinize the general ledger at the end i.e., only after verifying the subsidiary books like cash book, sales book, purchase books etc. The auditor should also confirm that the standard accounting practices are followed by the concern consistently.

Disclosure Requirements as per Companies Act

If there is any change in the method of accounting for the year under audit, the change in the method of accounting and the effect of such a change in the profit of the year under audit is to be disclosed in the financial statements (as per ASI).

Verification of Main Journal

The adjustment entries and closing entries are passed through journal. A thorough verification of each journal entry is necessary because a crafty entry may entirely change the picture of the financial position of the organization.

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Role of an auditor in Verification of Main Journal

Usually, the supporting documents for the journal entry will be the Minutes of the directors meeting, shareholders' meeting, copies of the correspondence, etc. Most of the documents would be internally generated. Hence, the auditor should obtain confirmation from outside wherever possible.

The outstanding liabilities and prepaid expenses disclosed in the previous year balance sheet are to be adjusted through the journal and the expenses pertaining to the current year but remaining outstanding and expenses that are prepaid during the year are adjusted in the respective ledger accounts through the main journal. Therefore, the auditor should carefully verify these items to ensure that the standard accounting principles and practices are not altered during the year under audit.

Some expenses or income pertaining to the year under audit, may be settled or collected only in the subsequent accounting year. Therefore, these amounts cannot be calculated accurately but can only be estimated roughly. Therefore, the auditor shall ensure that a reasonable basis is followed to estimate such amounts.

Disclosure requirements

If there is any departure from accounting practices or policies or if there is any change in the constantly followed method of accounting, the effect of such change or departure on the profit is to be disclosed in the financial statements.

5.3 DERIVATIVES

The auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities. Examples of such auditing procedures and the special skill or knowledge required include—

- Obtaining an understanding of an entity's information system for derivatives and securities, including services provided by a service organization, which may require that the auditor have special skill or knowledge with respect to computer applications when significant information about derivatives and securities is transmitted, processed, maintained, or accessed electronically.
- Identifying controls placed in operation by a service organization that provides services to an entity that are part of the entity's information system for derivatives and securities, which may require that the auditor have an understanding of the operating characteristics of entities in a certain industry.
- Understanding the application of generally accepted accounting principles for assertions about derivatives, which might require that the auditor have special knowledge because of the complexity of those principles. In addition, a derivative may have complex features that require the auditor to have special knowledge to evaluate the measurement and disclosure of the derivative in conformity with generally accepted accounting principles. For example, features embedded in contracts or agreements may

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require separate accounting as a derivative, and complex pricing structures may increase the complexity of the assumptions used in estimating the fair value of a derivative.

- Understanding the determination of the fair values of derivatives and securities, including the appropriateness of various types of valuation models and the reasonableness of key factors and assumptions, which may require knowledge of valuation concepts.
- Assessing inherent risk and control risk for assertions about derivatives used in hedging activities, which may require an understanding of general risk management concepts and typical asset/liability management strategies

Key Financial Risks

- The auditor obtains an understanding of the principal types of financial risk, related to derivative activities, to which entities may be exposed. Those key financial risks are:
- (a)Market risk, which relates broadly to economic losses due to adverse changes in the fair value of the derivative. Related risks include:
 - Price risk, which relates to changes in the level of prices due to changes in interest rates, foreign exchange rates, or other factors related to market volatilities of the underlying rate, index, or price. Price risk includes interest rate risk and foreign exchange risk;
 - Liquidity risk, which relates to changes in the ability to sell or dispose of the derivative instrument. Derivative activities bear the additional risk that a lack of available contracts or counterparties may make it difficult to close out the derivative transaction or enter into an offsetting contract. For example, liquidity risk may increase if an entity encounters difficulties obtaining the required security or commodity or other deliverable should the derivative call for physical delivery,
 - Economic losses also may occur if the entity makes inappropriate trades based on information obtained using poor valuation models, and
 - Derivatives used in hedging transactions bear additional risk, known as basis risk. Basis is the difference between the price of the hedged item and the price of the related hedging instrument.

Basis risk is the risk that the basis will change while the hedging contract is open, and thus, the price correlation between the hedged item and the hedging instrument will not be perfect. For example, basis risk may be affected by a lack of liquidity in either the hedged item, or the hedging instrument;

b)Credit risk, which relates to the risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter. For certain derivatives, market values are volatile, so the credit risk exposure also is volatile. Generally, a derivative has credit exposure only when the derivative has positive

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market value. hat value represents an obligation of the counterparty and, therefore, an economic benefit that can be lost if the counterparty fails to fulfill its obligation. Furthermore, the market value of a derivative may fluctuate quickly, alternating between positive and negative values. The potential for rapid changes in prices, coupled with the structure of certain derivatives, also can affect credit risk exposure. For example, highly leveraged derivatives or derivatives with extended time periods can result in credit risk exposure increasing quickly after a derivative transaction has been undertaken. Many derivatives are traded under uniform rules through an organized exchange (exchange-traded derivatives). Exchange traded derivatives generally remove individual counterparty risk and substitute the clearing organization as the settling counterparty. Typically, the participants in an exchange-traded derivative settle changes in the value of their positions daily, which further mitigates credit risk. Other or minimizing credit risk include requiring the counterparty to offer collateral, or assigning a credit limit to each counterparty based on its credit rating;

(c)Settlement risk is the related risk that one side of a transaction will be settled without value being received from the customer or counterparty. One method for minimizing settlement risk is to enter into a master netting agreement, which allows the parties to set off all their related payable and receivable positions at settlement

(d)Solvency risk, which relates to the risk that the entity would not have the funds available to honor cash outflow commitments as they fall due. For example, an adverse price movement on a futures contract may result in a margin call that the entity may not have the liquidity to meet; and

(e)Legal risk, whichrelates to losses resulting from a legal or regulatory action that invalidates or otherwise precludes performance by the end user or its counterparty under the terms of the contract or related netting arrangements. For example, legal risk could arise from insufficient documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in tax laws, or statutes that prohibit entities from investing in certain types of derivatives.

5.4 SUMMARY

Impersonal ledger connotes general ledger or nominal ledger. They fall into two types nominal and real accounts. Nominal accounts come under p& c a/c while real comes under balance sheet auditor should vouch there ledgers as there ledger offer a wider scope for manipulation by passing fictitious entries of expenses.

5.5 CHECK YOUR PROGRESS

1. State the general considerations to be exercised on auditing impersonal ledger.
.....
2. Explain the points to be considered by the auditor while audit the derivatives.
.....
3. Explain the role of an auditor for verification of main journal.
.....
4. Explain the different types of risk.
.....

5.6 KEY WORDS

Cut-off examination : It denotes procedures adopted to ensure separation of transactions at the end of the accounting period from there at the commencement of the next accounting period especially for such item that may overlap.

Ethics: Ethics refers to moral principles which give rise to certain statements of conduct of behavior having based on moral foundation.

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Unit -VI VERIFICATION AND VALUATION OF ASSESTS AND LIABILITIES

- 6.0 Introduction
- 6.1 Objectives
- 6.2 Auditor position regarding the valuation and verification of assets and liabilities
 - 6.2.1 Vouching and Verification
 - 6.2.2 Verification of Liabilities
 - 6.2.3 Confirmation and Verification
- 6.3 Verification
- 6.4 Valuation of Assets and Liabilities
 - 6.4.1 Components of Valuation
 - 6.4.2 Vouching, Verification and Valuation
- 6.5 Depreciation, Reserves and Provision
 - 6.5.1 Depreciation
 - 6.5.2 Reason of Depreciation
 - 6.5.3 Depreciation Methods
 - 6.5.4 Provision
 - 6.5.5 Reserves
- 6.6 Auditor's Duty Regarding Capital Reserves
- 6.7 Self assessment questions
- 6.8 Summary
- 6.9 Key words

6.0 INTRODUCTION

Verification means the inspection of assets appearing in financial statements, whether the assets are according to legislation or not. Verification of assets and liabilities are done to confirm the following –

- Existence
- Ownership
- Proper valuation
- Possession
- Freedom from encumbrances
- Proper recording

6.1 OBJECTIVES

Following are the objectives of Verification –

- Confirmation about the existence of assets through physical verification.

- Legal and official documents relating to assets are checked to confirm the ownership of assets.
- It is confirmed that assets are free from any charge of lien.
- Proof regarding proper valuation of assets.
- To confirm that assets are properly accounted for in the books of accounts.

6.2 AUDITOR POSITION REGARDING THE VALUATION AND VERIFICATION OF ASSETS AND LIABILITIES

6.2.1 Vouching and Verification

Both are considered to be same thing but there are lots of difference between vouching and verification.

Vouching relates to confirmation of the correctness and authenticity of accounting entries as appeared in the books of accounts whereas verification confirms the existence, ownership and valuation of assets as appears in the balance sheet. The Auditor's duty is not only vouching the entries appearing in the books because vouching cannot prove the existence of the related asset or liabilities at the balance sheet date.

6.2.2 Verification of Liabilities

Following are the objectives of verification of liabilities –

- Creditors reflect a true position as to liabilities of the business.
- All liabilities are disclosed in the balance sheet whether recorded in the books or not.
- Value of liabilities is according to the generally accepted accounting principles.
- Liabilities are properly classified and disclosed in the balance sheet.

6.2.3 Confirmation and Verification

Let us now understand what confirmation and verification is.

Confirmation

Auditor requires confirmation from third party and management about any fact or figure. Few of the examples in which the Auditor requires confirmations are as follows –

- Confirmation from debtors about balances.
- Confirmation from creditors about balances.
- Confirmation from banks about bank balances, fixed deposits, interest accrued, overdraft or cash credit limit balance, etc.
- Confirmation from financial institutions about loan and interests.
- Confirmation from management about contingent liabilities, etc.

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6.3 VERIFICATION

Verification means inspection of assets by the Auditor and it includes identification, weighing and counting of assets. Following items require physical verification –

- Land and Building
- Plant and Machinery
- Stock-in-hand
- Stores and consumables
- Investments
- Securities
- Cash-in-hand
- Bills receivable

Thus, confirmation and verification are altogether different processes of audit and both are equally important too.

6.4 VALUATION OF ASSETS AND LIABILITIES

Valuation means estimation of various assets and liabilities. It is the duty of Auditor to confirm that assets and liabilities are appearing in the balance sheet exhibiting their proper and correct value. In the absence of proper valuation of assets and liabilities, they will exhibit either overvalued or under-valued.

It is therefore required for an Auditor to exercise reasonable care and skill to analyze the basis of valuation from technical experts and satisfy himself that assets shown in Balance-sheet are properly valued accordance with the generally accepted conventions and accounting principles.

6.4.1 Components of Valuation

Methods of valuation of assets are as hereunder –

- **Cost Price** – This is the cost price paid at the time of acquisition of assets plus the freight charges, octroi charges, and commissioning and installation charges, etc. to bring that asset in usable condition.
- **Book Value** – This is the value as appearing in the books of accounts; the cost price less depreciation.
- **Realizable Value** – A Value which can be realized from the sale of assets.
- **Market Value** – A value which the asset can fetch at the time of sale.
- **Replacement Value** – A value on which an asset can be replaced.
- **Conventional Value** – It means the cost price less depreciation written off ignoring any kind of fluctuation in the price.

- **Scrap Value** – If the asset is not in working condition and sold as scrap, then the sale value of asset is scrap value.

Basis of Valuation

Auditor should ensure that the basis of valuation is correct and reliable. He should keep in mind the process of valuation which is as follows –

- Original cost
- Expected working hours of the assets
- Wear and tear expenses
- Scrap value
- Chances of asset become obsolete

Fixed asset is valued at cost price less depreciation and current assets should be valued at cost or market price whichever is less.

6.4.2 Vouching, Verification and Valuation

In vouching, accounting entries are checked with the bona-fide vouchers.

- Verification proves the **existence, ownership and title** of assets.
- Valuation certifies the **correct value of asset**.
- Vouching is done after **original entry** in the books of accounts.
- Verification and valuation are done at the **end of the financial year**.
- Vouching is done by **Senior Auditor and Audit Clerk**.
- Verification and valuation are done by the **Auditor** himself.
- Bonafide vouchers are sufficient **evidence** for vouching
- For Valuation Auditor has to depend upon **certification** from owner/partner/director.
- Verification is done by physical verification, title deeds and receipt of payment, etc.

6.5 DEPRECIATION, RESERVES AND PROVISION

In this chapter, we will discuss auditing related to Depreciation, Reserves and Provision. We will proceed by discussing Depreciation and move on to discussing Reserves and Provision further.

6.5.1 Depreciation

Value of depreciation reduces the value of assets on residual basis and also the current year profits.

Depreciation indicates the reduction in value of any fixed assets. Reduction in value of assets depends on the life of assets. Life of assets depends upon the usage of assets.

There are many deciding factors which ascertain the life of assets; in case of a building, the deciding factor is time, the deciding

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factor for leased assets is the lease period, the deciding factor for plant and machinery is both production and time. There may be many factors but ascertainment of life should be based on some reasonable basis.

6.5.2 Reason of Depreciation

Following are the main causes of depreciation –

Wear and Tear

One of the main reasons of depreciation is normal wear & tears, it depends upon the usage of machinery. More the machinery is in use, more will be the wear and tear. Wear and tear of a machine in use for one shift will be less than with a machine being used in two shifts.

Exhaustion

Some assets may lose their value due to consumption, for example, mines, quarries, oil wells and forest stands. Due to continuous extraction a stage will come where all above are completely exhausted

Obsolescence

New technology or invention may bring down the value of old asset and outdated technology become cheaper. For example, television became obsolete with the introduction of new LED Television, the users are discarded old televisions although they are in good condition.

Effusion of Time

Value of assets may reduce over a passage of time. For example, a patent becomes useless after expiry of the period of patent.

Other Causes

- Assets also lose their value due to weather conditions.
- Market value of assets may fall down drastically.
- Accidents also lead to a decrease in the value of assets.

Need for Depreciation

- To ascertain the true profit of the year, it is desirable to charge depreciation.
- To ascertain true value of assets, depreciation should be charged and without correct value of assets, true financial position of the company cannot be ascertained.
- Instead of withdrawal of overstated profit, it is desirable to make provisions to buy new asset and replace the old asset. Accumulated value of depreciation provides additional working capital.
- Depreciation help us to ascertain uniform profit in each accounting year.
- Depreciation is also useful to gain advantage o tax benefits.

Basis of Depreciation

The important factors related to the depreciation chargeable are as follows –

- Cost of Asset or of Asset
- Estimated life of an asset
- Scrap value of asset
- Addition and extension in asset along with date
- Provision of Companies Act and Income Tax Act for providing depreciation
- Working hours of an asset
- Working conditions of organization and handling skill of operator
- Major repairing that increases the life of an asset
- Chances of obsolescence of an asset

6.5.3 Depreciation Methods

Following are the methods of depreciation –

- Straight line method
- Written down value method
- Annuity method
- Insurance policy method
- Machine hour rate method
- Depletion method
- Revaluation method
- Depreciation fund method
- Mileage method
- Production unit method
- Global method
- Accelerated Method
- Double-declining Method
- Year's digit method

Depreciation may be charged by applying any of the above methods. We will discuss a few important methods –

Straight Line Method

Under this method, fixed amount of depreciation is charged every year. The formula to determine the amount of depreciation is as follows;

Written Down Value Method

It is also called the Diminishing Balance or the Reducing Balance Method. Under this method, a fixed percentage of depreciation is charged on written down value of asset. Written down value of asset means (Cost of asset – depreciation).

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Auditor's Duty Regarding Depreciation

The Auditor cannot be held responsible for estimating the working life of an asset; it is the job of an expert valuer.

- A company can adopt different methods for different type of assets provided that the methods are adopted consistently over the years.
- If a company opts to choose new depreciation methods, then depreciation should be recalculated applying new methods from the date on which the asset is put to use for the first time. The difference of amount of depreciation as charged with old rate and the amount calculated from new rate should be debited to profit and loss account in case of loss and difference should be credited to general reserve in case of profit.
- According to Schedule II of the Companies Act, if asset is sold or discarded during the year, depreciation will be charged on pro-rata basis up to date of sale or discard. Similarly, depreciation will be charged on pro-rata basis, in case of addition to fixed asset.
- Account must disclose method of depreciation.
- Depreciation must be according to provisions of Companies Act and Income Tax Act.
- If depreciation is charged more than prescribed rate, Auditor should examine whether it is based on some professional and technical advice.
- Depreciation should be charged on revalued amount, if there is revaluation of assets.

6.5.4 Provision

Provisions means “any amount written off or retained by way of providing depreciation, or diminution in the value of assets or for providing any known liability of which the amount cannot be determined with substantial accuracy.” -

The Institute of Chartered Accountants of India

Debiting Profit and Loss account, provisions are created and shown either by deduction on the assets side or on the liabilities side under relevant subheads in the balance sheet.

Provision for bad and doubtful debts, provisions for repair & renewals, provision for discounts and depreciation are the most common examples of provision.

6.5.5 Reserves

Reserve is an appropriation of profit and on the other hand, provision is a charge against profit. Reserves are not meant to meet out contingencies or liabilities of business. Reserve increases working capital of a company to strengthen the financial position. There are two types of reserves –

Capital Reserve

Capital reserve is not readily available for distribution as dividends among the shareholders of the company and it is created only out of capital profit of the company; this works like premium on issue of shares or debentures and Profit prior to incorporation.

Revenue Reserve

Revenue reserves are readily available for distribution of profit as dividend to the shareholders of the company. Some of the examples of revenue reserves are - general reserve, staff welfare fund, dividend equalization reserve, debenture redemption reserve, contingency reserve, and investment fluctuation reserves.

6.6 AUDITOR'S DUTY REGARDING CAPITAL RESERVES

Auditor should examine the following –

- Capital reserve can be created out of capital gains only.
- If the Article of the company permitted, capital reserve can be utilized for the distribution of dividends.
- Capital reserve should be shown separately from revenue reserve and general reserve in the balance sheet.

Secret Reserves

Banking companies, insurance companies and electricity companies create secret reserves, where public confidence is required. In this case, to create secret reserve assets are shown at lower cost or liabilities at higher value; following examples will help you understand how this is done –

- By undervaluing goodwill or stock.
- By excessive depreciation.
- By creating excessive provisions.
- Showing free reserves as creditors.
- By charging capital expenditure to profit and loss account.

Auditor's Duty Regarding Secret Reserves

Duties of Auditors regarding secret reserves are as follows –

- Creation of secret reserve is not permitted by the Companies Act.
- Only Banking Company, Insurance Company and Electricity companies are allowed to create secret reserve.
- In some cases where the creation of secret reserves is allowed under the Companies Act, the Auditor should examine the necessity of creating such a reserve. If the Auditor is satisfied he need not to qualify his report.

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General and specific Reserves

Specific reserves are created and utilized for the purpose only for which they are created like dividend equalization reserve and debenture redemption reserve.

General reserves are created for any future contingency or to utilize at the time of expansion of business. The purpose behind the creation of general reserve is to strengthen the financial position of the company and to increase the working capital.

Auditor’s Duty Regarding General Reserves

There is no liability on the Auditor’s part to report on the creation, adequacy or inadequacy of such reserve. He may advice to the management towards the long term interests of the company.

Auditor’s Duty Regarding Specific Reserves

The Auditor should examine that specific reserve should not be available for distribution as this reserve is meant to meet out specific liabilities only.

6.7 CHECK YOUR PROGRESS

1. What is verification?
.....
2. What do you mean by verification of assets.
.....
3. What are the object of verification?
.....
4. What is meant by valuation?
.....
5. What is meant by verification of assets and liabilities? What is the object of such a verification?
.....

6.8 SUMMARY

Verification means ‘Proving in truth’ or ‘ confirmation’. An auditor has not only to see the arithmetical accuracy and bonafides of the auditor has not only to see the arithmetical accuracy and bonafides of the transactions in the books of account by vouching only, but has also to see that the assets as recorded in the balance sheet actually exist. The fact that there is an entry regarding the purchase of an asset and which entry has been found to be concern at the date of the balance sheet. It is possible that after the asset had been acquired and the necessary entries made in the books of account, the asset might have been disposed of or pledged or mortgaged and no entry had been made regarding these facts in the books of account before the closing of the financia] year. He has also to see whether a particular asset as recorded in the balance sheet on the day of the closing of the books of accounts exists or not.

The valuation of the assets should be done by the responsible officer of the concern and the auditor has to see whether they have been properly valued or not. For this purpose he should obtain the certificates

of values and other competent persons. He can always rely upon these certificates and should also mention this fact in his report.

6.9 KEY WORDS

- Secret reserve: Reserve which are not disclosed the balance sheet are called secret reserve
- Special reserve: Specific reserve is one created for some definite purpose out of the profit of the company
- Provisions: Provisions are amounts charged against the revenue to provide for depreciation, renewal or diminution in the value of assets or a known liability the amount where of cannot be determined with substantial accuracy a claim which is disputed

*Verification and
Valuation of Assets and
Liabilities*

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UNIT VII COMPANY AUDIT APPOINTMENT REMUNERATION REMOVAL

- 7.0 Introduction
- 7.1 Objectives
- 7.2 Appointment Auditors
 - 7.2.1 Qualification of an Audits
 - 7.2.2 Disqualifications of an Audits
 - 7.2.3 Appointment of auditors - Section 224
 - 7.2.4 Removal of an auditor - Section 224 (7) and Section 225
 - 7.2.5 Removal after the Expiry of the term
 - 7.2.6 Remuneration of an Auditor
- 7.3 Self Assessment Question
- 7.4 Summary
- 7.5 Key words

7.0 INTRODUCTION

In this lesson you are being told about the appointment, powers, duties and liabilities of the auditor. You have already known about the importance of a auditor in a Company, whether a Public Ltd. Company or a Private Ltd. Company. The accounts of the Company are to be audited annually by a qualified auditor. Hence the question is, who is a qualified auditor. The answer to this question can be sought in Section 226 of the Companies Act, which states, "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". A firm whereof all the partners practising as a Chartered Accountants in India, may also be appointed by its firm's name as an auditor of a company and the partner of the firm may act in the name of the firm.

7.1 OBJECTIVES

The audit of a joint stock company is intended for the protection of the shareholders and the auditor is expected to examine the accounts maintained by the director with a view to informing the shareholders of the true financial position of the company.

7.2 APPOINTMENT AUDITORS

- i. a body corporate (because of its characteristic feature of limited liability); or
- ii. an officer or employee of the company under audit; or
- iii. a person who is a partner, or who is in the employment of an officer or employee of the company; or

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- iv. a person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee for an amount exceeding one thousand rupees; or
- v. a person holding security, i.e. an instrument which carries voting rights of that company; and
- vi. under section 226 (4), a person who has been disqualified for appointment as an auditor of a company on above-mentioned grounds, shall also not 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.

7.2.1 Qualification of an Audits

A person holding a certificate under the Restricted Auditors Certificate (Part B States) Rules 1956, is also qualified to act as an auditor of a company.

The Central Government has powers to make rules providing for the grant, renewal, suspension or cancellation of such certificates to persons. It also has got powers to prescribe conditions and restrictions for such purposes. But it has to notify to this effect in the official gazette (Section 216(2) (b)).

Thus to be a qualified, auditor should have passed the examination of the Institute of Chartered Accountants of India and be a member of the Institute of the Chartered Accountants : or

He should hold a certificate of practice under the Restricted Auditors Certificate (Part B States) Rules 1956.

If he does not possess either of the qualifications, he is not qualified to act as an auditor of a company.

7.2.2 Disqualifications of an Audits

From the above it is clear that the following can not act as an auditor of a Company : [Section 226 (3)]. & (4)

- i. a body corporate ;
- ii. an officer or an employee of the company. (Officer here means a director, managing director, manager or secretary);
- iii. a person who is a partner or who is in the employment or an officer or employee of the company;
- iv. a person who owes the company more than Rs. 1,000/- or who has given a guarantee of provided any security in connection with the indebtedness of any third person to the company amounting to more than Rs. 1,000/-.
- v. a person who is disqualified for appointment as an auditor of the company's subsidiary or holding company or a subsidiary of a holding company.
- vi. A person holding any security after a period of one year from the date of commencement of the companies (Amendment) Act, 2000.

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Thus it is quite clear that the persons governed by the above stated clauses of Sec. 226(3) are disqualified from being appointed as an Auditor of a Company.

7.2.3 Appointment of auditors - Section 224

Under section 224 of the Act detailed provisions regarding appointment of statutory auditors have been laid down. This section [except sub-sections 224 (A) and 224 (1B)] is applicable to all kinds of companies. The Act has vested the power to appoint auditors with directors, shareholders, the Central Government and the Comptroller and Auditor General of India.

Appointment by directors

* First Auditors (i) The board of directors shall appoint the first auditor(s) of a company within one month of the date of registration of the company by a valid resolution.

(ii) The auditor so appointed shall hold office till the conclusion of first annual general meeting.

* Casual Vacancy - The directors have been empowered to fill any casual vacancy in the office of the auditor, except one, which is caused by prior resignation of an auditor. Any auditor appointed in a casual vacancy shall hold office until the conclusion of next annual general meeting.

Appointment by shareholders

- First Auditors - In case the directors fail to appoint first auditor(s), the shareholders shall appoint the auditor at a general meeting by passing a resolution.
- Subsequent Auditors

(i) By ordinary resolution

As per provisions of section 224 (1), subsequent auditors are to be appointed at each annual general meeting by the shareholders by passing a resolution. The auditor so appointed shall hold the office from the conclusion of that meeting until the conclusion of the next annual general meeting.

(ii) By special resolution

1. 'Body corporate' connotes a wider expression than company and is used under the Companies Act to denote a company incorporated in India, a foreign company, a public financial institution, a nationalised bank and also a corporation formed under any special Indian or foreign law except as expressly excluded by the definition.

In case of certain companies, the auditor is to be appointed only with the approval of the company by a special resolution. Section 224A lays down that in case of a company, in which not less than twenty-five per cent of the subscribed share capital¹ is held, whether singly or in any combination, by :

(a) a public financial institution or a Government company or Central Government or any State Government; or

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(b) any financial or other institution established by any provincial or State Act in which a State Government holds not less than 51% of the subscribed share capital; or

(c) a nationalised bank or a general insurance company.

The auditor is to be appointed or re-appointed by a special resolution only.

(iii) In case of appointment of subsequent auditors the company must inform the auditor within seven days of appointment;

(iv) The auditor within seven days of receipt of information from the company, must inform the Registrar in writing whether he has accepted or rejected it.

* Casual Vacancy—If a casual vacancy in the office of auditor arises by his resignation, such vacancy should only be filled by the company in a general meeting. In case a casual vacancy arises because of any other reason except resignation, the shareholders can appoint the auditor only if directors fail to fill the vacancy.

Appointment by the Central Government

- i. If a company, at an annual general meeting, fails to appoint or re-appoint an auditor(s), the Central Government may appoint a person to fill the vacancy under powers conferred upon it by section 224(3). The expression, 'fails to appoint or re-appoint' also includes refusal to accept the appointment by the auditor.
- ii. The said company has to give notice of the above fact to the Government and, if a company fails to give such notice within seven days of the annual general meeting, the company and every officer of the company who is in default shall be punishable with fine, which may extend up to five thousand rupees.
- iii. The appointment by the Central Government is made from the panel of names suggested by the applicant company.
- iv. It may be noted that if appointment of a person as an auditor is void ab initio, it should not be treated as a casual vacancy, rather this would give rise to powers of the Central Government under section 224(3).

Appointment by the Comptroller and Auditor General

In case of Government companies, the Comptroller and Auditor General appoints or re-appoints the auditor(s).

Compulsory re-appointment

Ordinarily, an auditor appointed by whatsoever authority, is to be compulsorily re-appointed by passing a resolution at the annual general meeting. However, the retiring auditor shall not be re-appointed in the following cases :

1. Subscribed share capital includes equity as well as preference share capital.

- i. if he is not qualified for re-appointment; or

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- ii. if he has given the company notice in writing about his unwillingness to be re-appointed; or
- iii. if a resolution has been passed at the meeting—
 - (a) appointing somebody other than him; or
 - (b) providing expressly that he shall not be re-appointed; or
- iv. if a notice has been given of any resolution proposing the appointment of some other person in place of the retiring auditor (even if such a resolution could not be proceeded with due to death, incapacity or disqualification of that person proposed as auditor); or
- v. if auditor is unable to comply with the ceiling on number of audits under section 224(1B).

Even for re-appointment of a retiring auditor, passing of a resolution is essential. There cannot be any automatic re-appointment.

Ceiling on number of Audits

A person of a firm can act as an auditor of a limited number of companies. No company or its Board of directors shall appoint or reappoint any person (who is in full time employment elsewhere), or a firm as its auditor, if such a person or a firm is, at the date of such appointment or reappointment holding appointments as auditor of the specified number of companies. However the 'specified number' will not include audit of private companies.

Special Resolution and the appointment of an Auditor

The Companies Amendment Act 1974, by its Section 224-A, requires passing of a special resolution for the appointment or re-appointment of an auditor(s) at the each annual general meeting, in case of companies where less than 25% of the subscribed capital is held whether singly or in any combination by.....

- a. a public financial institution or a Government Company or a Central Government or any State government; or
- b. any financial or other institution established by any Provincial or State Act in which the State Government holds not less than 51% of the subscribed share capital or;
- c. a nationalized bank or an insurance company carrying on general insurance business.

Failure to pass a special resolution in the annual General Meeting by the Company, gives a right to the Central Government to appoint a person(s) to be the auditor of the company.

7.2.4 Removal of an auditor - Section 224 (7) and Section 225

The removal of an auditor can be discussed under the following heads :

1. Removal before the expiry of the term—section 224 (7) of the Act includes provisions relating to removal of an auditor of a company before the expiry of term. These are :

(a) Removal of first auditor :- The company (and not the board of directors) in a general meeting can remove the first auditor appointed by the directors before the expiry of the term. In this case the prior approval of the central Government is not needed for removal of first auditor.

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(b) Removal of subsequent auditor :- Any subsequent auditor can be removed from office before the expiry of his term, by the shareholders at a general meeting only after obtaining the prior approval of the central government.

The only purpose of obtaining the prior approval of shareholders through general meeting and the central government is to prevent directors of the company to remove an auditor without adequate and justified reasons.

7.2.5 Removal after the Expiry of the term

The auditor can be removed after the expiry of his term of office, as per the procedures laid down in section 225. According to the section, for removal of a retiring or appointing another auditor in his place, the following procedures must be observed.

1. Special notice : A special notice of intention to move such resolution must be given to the company by shareholders (holding ten percent voting rights), who wish to nominate some other person for appointment, at least fourteen (14) days before the annual general meeting.
2. Notice to be sent to retiring auditor : On receipt of such a notice, the company must send a copy thereof to the retiring auditor.
3. Right of retiring auditor make a representation : The retiring auditor has a right to make a written representation (not exceeding a reasonable length) to the company. He may also ask the company to notify such representatives to the shareholders of the company.
4. Right to get representation circulated : The company, on receipt of representations, shall mention the fact of representations being made in the notice of the meeting and send a copy thereof to every member of the company to whom the notice of one meeting is sent. However, if the representations are not sent because of the default of the company or late receipt, these may be read out during the meeting.
5. Ground for exemption : If the central government, on the application by the company or any other aggrieved person, is satisfied that the auditors securing needless publicity or defamatory publicity, it 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 to be removed has right to attend the general meeting where his removal is to be discussed. He has also a right to speak at such meeting.
7. Passing of resolution : The general meeting may, by passing a resolution remove the auditor.

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7.2.6 Remuneration of an Auditor

The appointing authority fixes the remuneration of an auditor. Thus it is clear that where the auditor is appointed by the Board, it is to fix the remuneration; if he is appointed by the Share Holders in the General Meeting, the remuneration is to be fixed in the Annual General Meeting ; if he is appointed by the Central Government, the remuneration is to be fixed by it. The General Meeting can also lay down the manner of fixing the remuneration.

The retiring auditor, when reappointed in the General Meeting, shall get the remuneration, which he was already getting, in the absence of any resolution passed for refixing his remuneration.

When an auditor is required to do some extra work, he is entitled to claim extra-remuneration for such work. Such extra-remuneration payable to him is to be shown in the Profit and Loss Account of the Company also. (Schedule VI Part II Clause B).

Any sum paid by the Company in respect of the auditor(s) expenses shall be deemed to be included in his remuneration.

7.3 CHECK YOUR PROGRESS

1. What are the qualifications prescribed for an auditor of a limited company? State the mode of appointment of casual vacancy of an auditor?
.....
2. Write short note on:Removal of an auditor.
.....
3. How are auditors appointed?
.....
4. Explain the statutory provision with regard to appointment and remuneration of auditors of a limited company?
.....

7.4 SUMMARY

The audit of a joint stock company is intended for the protection of the shareholders and the auditor is expected to examine the accounts maintained by the directors with a view to informing the share holders of the true financial position of the company. Section 226 of the Companies Act contains provisions relating to the qualifications and disqualifications of a Company’s auditor. An auditor must possess the following qualifications. He should be chartered Accountant within the meaning of the Chartered Accounts Act, 1949. If a firm is appointing as the auditor, all the partners of the firm must be Chartered Accountants. According to Section 226(2) a person who holds a certificate under the restricted auditors certificates (Part B states) Rules 1956, is also qualified to Act as auditor of a company.

Every company must, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of the meeting ot the conclusion of the next annual general mètting. The first auditors of accompany are appointed by its Board of directors within one month of

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its incorporation. The auditors so appointed hold office until the conclusion of the first annual general meeting. The company may, at a general meeting remove any or all such auditors and appoint any other persons. At the expiry of the term of an auditor, the company may in the annual general meeting appoint another person in his place. But a special notice of an intention to nominate a person other than retiring auditor at the annual general meeting must be given to the company. On receipt of notice of such a resolution, the company must forthwith send a copy hereof to the retiring auditor. The auditor has the right of making representation in writing to the company. The company must send a copy of the representation so derived by the auditor, to every member of the company to whom notice of the meeting is sent. If a copy of the representation is not sent as aforesaid the representation must be read out at the meeting.

7.5 KEY WORDS

Partial Audit : It is one conducted at the close of financial year when all accounts are audited.

Peer Review : A peer review is one when one audit firm's procedure is independently reviewed by another firm.

Professional ethics : professional ethics are those moral standards of conduct for the members of a profession.

Audit risk : It refers to risks of material misstatement and detection risk.

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UNIT VIII POWERS AND DUTIES OF AN AUDITOR

- 8.0 8.0 Introduction
- 8.1 8.1 Objectives
- 8.2 8.2 powers and duties of auditors
 - 8.2.1 Powers
 - 8.2.2 Duties
- 8.3 Auditor Report
 - 8.3.1 Types of Audit Report:
 - 8.3.2 Maintenance of books and records
- 8.4 Self Assessments questions
- 8.5 Summary
- 8.6 Key words

8.0 INTRODUCTION

It has stipulated specific qualification for a person to undertake such an audit. Auditor is appointed under companies Act on behalf of shareholders. Besides there are other stakeholders like, financiers, government, customers, suppliers, regulatory bodies, employees and others who are interested in ascertaining the financial status of a corporate entity. Financial statement released after the audit of accounts carry more reliability among the stakeholders.

These statements serve as a window to witness the financial affairs of a corporate entity. Only an auditor can ensure the truthfulness and fairness of financial statement. In this backdrop let us discuss the interface between auditor and company.

Companies Act has bestowed on the auditor the following rights and powers.

8.1 OBJECTIVES

This chapter attempts to expose the students on the rights, duties, and liabilities of an auditor.

8.2 POWERS AND DUTIES OF AUDITORS

8.2.1 Powers

An auditor gets the following rights and powers from the companies Act, to enable him to discharge his duties as an Auditor in a faithful manner.

1. Right to inspect books of accounts (S, 227(1))

The auditor has a right to see the books and the vouchers of the Company, at all times, The books here mean the account books as well as the Statutory, statistical and costing books, Vouchers mean documentary evidence of any nature concerning the books and accounts under Audit,

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He has a right of free and complete access at all times of even the books and vouchers of the Branch. This has been decided in 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 a right to call information and explanations from the directors and officers of the Company. This information and explanation should be necessary for discharging his duties as an auditor while auditing the books of account of the Company.

3. Right to get notice of the general meeting and attend it. (S. 231).

The auditor has a right to receive notice of the general meeting and attend it. It is not necessary that the accounts of the Company are to be discussed in these meetings. He can attend every meeting of the shareholders.

4. Right to make a statement in the meeting.

The auditor has a right to make statement in the shareholder's meeting relating to the accounts of the company only. But he is not bound to make any statement, unless the Chairman of the meeting asks him to do so. In such a case also, he should answer questions relating to accounts only.

5. Right to be indemnified. (Section 633).

The auditor has a right to be indemnified out of the assets of the company for all legitimate expenses incurred by him in defending a law suit filed against him for any Civil or Criminal proceedings, provided he has been acquitted in these cases by the court.

6. Right to visit the Branches.

The auditor has a right to visit each and every branch of the company, in connection with the audit of these branches or of the Company, provided these branches do not have a separate auditor and further, these branches have not been granted exemption by the Central Government for being audited.

7. Right to take legal and technical advice.

The auditor has a right to take legal, expert or technical advice in connection with the performance of his work. But he should give his own opinion in the audit report and not that of the experts. Such a decision has been given in Re : London and General Bank (1895).

8. Right to ask for remuneration.

The auditor has a right to ask for the remuneration, after completing the audit work of the company. In case of his dismissal after his appointment too, he is entitled to his fees.

9. Right to sign the audit report (S. 229).

The auditor has a right to sign the audit report. But where the auditor is a firm, a partner of such firm has a right to sign the audit report, provided he is a practising Chartered Accountant in India. Such partner is

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also entitled to sign or authenticate any other document of the Company required by law to be signed or authenticated by the auditor.

10. Right to correction of wrong statements.

The auditor has a right to correct any wrong statement made by the directors in the general meeting. But this statement must relate to the accounts of the company which he has audited.

8.2.2 Duties

Duties of an auditor can be stated under two heads : A. Duties under the Companies Act; and B. Duties as per the Legal Decisions. Let us see these duties under these heads separately.

A. Duties under the Companies Act

The auditor has the following duties under the Companies Act:

1. To make special enquiries and investigations in connection with the following matters (Sec. 227 (IA)).

- i. whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interest of the company of its members;
- ii. whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;
- iii. where the company is not an investment company within the meaning of Section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company ;
- iv. whether loans and advances made by the company have been shown as deposits ; (v) whether personal expenses have been charged to revenue accounts ;
- v. whether it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

2. To make report to the shareholders. (Section 227 (2, 3 & 4)).

The auditor of the company is duty bound to make report to the members of the company on the accounts examined by him and on every balance sheet, every profit and loss account laid before the company in the general meeting during his tenure of office. The auditor has to make a report to the members and not to the directors, though his appointment may have been made by the directors. The duty of the auditor is over as soon as he submits the report to the Secretary of the company. It is none of his concern to know whether the same has reached to the hands of the members of the company.

The Audit Report must expressly state the following besides other necessary things ;

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- a. whether in his opinion and to the best of his information and according to the explanations given to him the accounts give the information required by the Act and in the manner so required.
- b. Whether the balance sheet gives true and fair view of the company's affairs as at the end of the financial year and the profit and loss account gives a true and fair view of the profit and loss of its financial year;
- c. whether he has obtained all the information and explanations required by him for the purposes of his audit;
- d. whether, in his opinion, proper books of account as required bylaw have been kept by the company, and proper returns for the purposes of his audit have been received from the branches not visited by him;
- e. whether the company's balance-sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

3. Duty to state the reasons for the answers in negative.

In case of the answers to any of the points stated above are in negative, the auditor is required to explain the reason for the answer in his report.

4. Duty to include in the report the matters as directed by the Central government.

Section 227 (4A) empowers the Central Government to require by order, that the auditor's report will include a statement on such matters as may be specified therein. Before making any such order the Central Government may consult the Institute of Chartered Accountants of India in regard to the classes of description or companies and other ancillary matters proposed to be specified therein.

5. Duty to sign the audit report. (Section 229).

It is the duty of the auditor to sign the audit report before sending is to the secretary of the company.

6. Duty to give a report upon the Prospectus (Section 56 (1)).

The auditor is required to give his report upon the Prospectus issued by an existing company. He should also give his report on the assets, liabilities and Profit and Loss of such company.

7. Duty to certify the Statutory Report. (Section 165 (4)).

The auditor has to certify the correctness of the Statutory Report with regard to the following:

- a. the number of shares which have been allotted by the company whether for cash or for consideration other than cash;
- b. the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;
- c. an abstract of the receipt of the company and the payments made.

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8. Duty to declare the solvency of the Directors, (Section 488 (2) (b)),

The auditor has to declare that solvency of the directors in case of the Voluntary Liquidation of the company,

9. Duty to give a report upon the Profit and Loss Account and the Balance Sheet enclosed with the Declaration of Solvency. (Section 488 (2) (b)).

The auditor has to give his report upon the profit and loss account and the balance sheet which is enclosed with the Declaration of solvency made by the Directors of the company, in the case of Voluntary Liquidation of the Company,

10. Duty to assist the Investigators (Section 240 (v) (b)).

In case the affairs of the company are to be investigated, the auditor should assist the Investigators in every possible manner. He should produce his working papers relating to audit when asked for by the Investigators.

11. Duty to assist the Advocate General.

If the Advocate General is making any enquiry against the directors, the auditor is duty bound to help him in his work.

B. Duties According to the Legal Decisions

Certain matters have been taken to the court of law from time to time and the courts have in their decisions fixed certain duties upon the auditors. These duties in short are enumerated here.

1. Duty to inform the members and shareholders about the contravention of the provisions of the company Law.
2. Duty to enrol himself with the Institute of Chartered Accountants of India and to obtain a certificate to practice from it.
3. Duty to acquaint himself with the provisions of the company law and also enquire from his predecessor about it in writing,
4. Duty not to canvass for and also approach and press any member of the company for his appointment as an auditor of the company.
5. Duty to enquire about the true and fair state of affairs of the company and submit his proper report.
6. Duty to verify himself cash in hand and not to be negligent in his work.
7. Duty to see the Debenture Trust Deed and verify whether the debentures issued by the company are according to 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 personally inspect all securities and see that they are in the safe custody of the Secretary of the Company.

Various courts have penalised the auditors for non-performance of the above stated duties and therefore, the auditor should take note of these duties also.

8.3 AUDITOR REPORT

An Auditor gives his opinions through Audit Reports; opinions such as the following –

- whether financial statements give true and fair view of profit or loss and state of affairs.
- whether the prescribed particular of statement submitted with the report are true and correct.

According to Rule 64 of Income Tax Rule –

- If accounts of the business are required to be audited under any law, then the Auditor has to submit his report in form 3(CA) first, but for the statement, it has to be in a particular form 3(CD).
- If accounts of business are not required to be audited under any law, then the Auditor has to submit his report in form 3(CB) first, but for the statement, it has to be in a particular form 3(CD).
- If person is occupied in some profession, form 3(CC) is to be used for audit report and form 3(CE) for statement of particulars.

8.3.1 Types of Audit Report:

An audit-report can be of two types: 1. Clean or Unqualified Report - If the auditor is fully satisfied on the facts to be incorporated in his report, he shall submit a clean or unqualified report on the Final Accounts. Such a report shall be given on the accounts regarding which the auditor does not find any irregularity or fallacy and about which there is no complaint and the auditor has no suspicion about their being true and fair. A report being clean means the auditor has performed the following acts: (a) Adequate examination of books. (b) Follow-up of generally accepted principles of auditing. (c) Adoption of necessary procedures as demanded by particular circumstances. (d) Use of reasonable skill and care

2. Qualified Report - If the auditor is not satisfied regarding the facts to be mentioned in his report, he must mention his dissatisfaction in his report. Such a report is called Qualified Report. By and large, the following reasons may be ascribed to a Qualified Report: (a) The auditor could not adopt the necessary audit procedures in the examination of the accounts for want of necessary evidence in the form of vouchers or documents. (b) The generally accepted principles of auditing have been violated. (c) The auditor may not have received adequate information and explanations sought by him, e.g., the accounting system may be incomplete. (d) There may be some inconsistency in the principles of accounting adopted by the company from year to year, e.g., the closing stock may not have been valued on the lines of last year and the change may not be acceptable to the auditor. (e) Any other reason for which the auditor may be dissatisfied.

8.3.2 Maintenance of books and records

8.3.2 The auditor of the company appointed u/s 224 of the Companies Act, 1956 is required to report u/s 227(2) & 227 (3) and

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227(4A) which may be classified into two categories: 1. Statement of opinion: a) Opinion on true & fair view: Section 227(2): Whether in his opinion and to the best of his information and according to the explanations given to him, the accounts give the information required by the Act in the prescribed manner and also given a true and fair view of the company's affairs in its balance sheet and correct picture of the profit or loss during the relevant financial year. b) Opinion on principal assertion: Section 227 (3) (b): Whether, in his opinion, proper books of accounts as required by law have been kept by the company so far as it appears from his examination of those books, and proper returns, adequate for the purposes of his audit have been received from branches not visited by him. 2. Statement of facts: Report on principal assertions. Section 227 (3) (a): Whether he has obtained all the information and explanations, which to the best of his knowledge and belief were necessary for the purpose of his audit. Section 227(3) (bb): Whether the report on the account of any branch office audited under section 228 by a person other than the company's auditor, has been forwarded to him as required by section 228 (3) (c) and how he has dealt with the same in preparing the auditor report. Section 227(3)(c): Whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns. Section 227(3)(d): Whether the profit and loss account and balance sheet comply with accounting standards referred to in section 211(3) (c) Section 227(3) (3): Auditor's report shall state his observations or comments, which have any adverse effect on functioning of the company in thick type or in italics. Section 227(3) (f): Whether any directors are disqualified from being appointed as director under section 274(1).

8.4 CHECK YOUR PROGRESS

1. Explain the power of the Auditor.
.....
2. Explain the duty of the Auditor.
.....
3. Explain the types of the Auditor.
.....

8.5 SUMMARY

The final phase of the audit process is audit report. It is a vehicle through which auditor conveys his findings to all stakeholders. The preparation of financial findings to all stakeholders. The preparation of financial statement is the responsibility of the management while making report to the members of the company while making report to the members of the company on the basis of books of accounts and financial statements is the responsibility of an auditor. The messages conveyed by auditor through audit report are based on the conclusion arrived at by him during the course of his examination of books of accounts of course it is very difficult to state the exact figures of various assets and liabilities. But he can certify whether financial statement are true and fair. The opinion of auditors arrived after judgement on the same set of books may vary to a reasonable extent.

8.6 KEY WORDS

Qualified report : The audit report given by auditor when he is not able to give a concrete opinion for one or more reasons is called qualified report.

Clean report

Audit report given by the auditor after being satisfied with truth and correctness of financial statement of accounts without any qualification is called clean report.

Audit planning: Audit planning is the process of deciding in advance what is to be done: Who is to do it how it is to be done by the auditor in order to have effective and efficient completion of audit.

Audit report

It is auditor's expression of opinion regarding the fairness of financial statement in reflecting the financial results and the financial position of the organization .

*Powers and Duties of
an Auditor*

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UNIT IX SHARE CAPITAL BRANCH AND COST AUDIT

- 9.0 Introduction
 - 9.1 Objectives
 - 9.2 Steps involved in issue of shares
 - 9.2.1 Verification of allotment and money received on allotment
 - 9.2.2 Verification of calls
 - 9.3 Alteration of Capital
 - 9.4 Self Assessment Questions
 - 9.5 Summary
 - 9.6 Key words
-

9.0 INTRODUCTION

Capital means money invested in the business at various points of time. In the case of companies, capital is contributed by many persons call shareholders. The growth and progress of a corporate entity hinges on so capital structure. Companies raise capital from the public. The capital the company has been classified into authorised, issued, subscribed, called up, paid up uncalled and reserve capital.

Classifications of Capital

1. Authorised capital or Nominal Capital: This amount is fixed in keeping with the long term and short term requirement of the company by promoters. This amount is stated in the Memorandum of Association (MOA). It can be altered by altering the MOA.
2. Issued capital: It is a part of authorised capital issued to the public. Companies issue capital to the public according to its requirements at various points of time.
3. Subscribed capital: This part represents shares subscribed by the public. It is not likely that the entire capital issued may be taken up by the public. In such a case, it will be less than the issued capital.
4. Called up capital: This amount indicates that part of subscribed capital that has been called up on share. E.g. If the value of a share is no, out of which Rs.5 may be called up on each share. In this case, called up capital per share is Rs.5.
5. Paid — up: This is that part of subscribed capital which is paid up by shareholder. The amount not paid by shareholder is called “calls in arrear”.
6. Uncalled capital: It refers to the amount yet to be collected on the shares. Shareholders have to pay when calls are made.
7. Reserve capital: It is that part of capital which is called up only in the event of winding up of a company.

FORMS OF CAPITAL

The Capital is mobilised in the following forms:

1. Equity capital: The capital is mobilised by issue of equity shares.
2. Preference share capital: It connotes the capital raised through issue of preference shares.
3. Debenture capital: Money raised through the issue of debentures. It represents long-term loan taken by the company. It is a loan capital.
4. Public Deposits: Money taken from the public by way of deposit represents loan. This is also called a loan capital.

AUDIT OF SHARE CAPITAL

Statutory auditor has to focus on share capital items with regard to the truth and fairness of available information. He should ensure that the provisions of Acts like Companies Act, 1956 and SEBI Act, 1992 with regard to capital are not violated. In this context, audit of share capital assumes a singular significance. The share capital is undertaken both at the inception phase as well as at later phases whenever capitals are raised.

9.1 OBJECTIVES

- Classification of Capital Forms of Capital
- Audit of Share Capital
- Audit of shares issued at premium and at discount
- Audit of Bonus Shares
- Audit of Calls in rear and Calls in advance
- Audit of for Forfeited shares and Reissue
- Audit of issue and redemption of preference share
- Audit of Alteration of capital and Capital Reduction
- Audit of Shares Transfer
- Audit of buying back of shares.

9.2 STEPS INVOLVED IN ISSUE OF SHARES

1. Authorised Capital

The amount of authorised capital can be verified in the light of Memorandum of Association. Auditor is advised to go through the audited balance sheet of the previous year.

2. Issued Share Capital

- Auditor should verify the amount of issued share capital with reference to previous years audited balance sheets of the company.
- He has to check whether Transactions of shares, namely issue, alteration, transfer etc. have been authorised by Memorandum of Association and Articles of Association.
- Company has adhered to the provisions of Companies and Act 1956 and SEBI Act 1992.
- Transactions have been recorded to represent true and fair picture.

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- He has to ensure that application money received is deposited in a scheduled bank and to ensure that share allotment has been after receipt of minimum subscription.
- He has to ensure payment of authorised rate of commission and brokerage to broker and underwriters.
- He has to ensure that rights shares have been offered to the existing shareholder.
- He should confirm the efficacy of internal check system in practice for issue of shares.
- He has to ensure that company has obtained permission properly from the stock exchange concerned for the issue of shares at one or more exchanges and to ensure that such a permission has been obtained few weeks before the closure of subscription list.
- He has to confirm that the guidelines issued by SEBI have been followed in the light of reports of lead managers.
- He has to verify whether conditions laid down for have been entering preliminary contracts have been fulfilled.
- The Auditor has to check whether provisions of Act relating into
 - Issue of shares at a premium sec 78
 - Issue of shares at a discount sec 79
 - Issue of sweat equity (sec 79A), have been complied with

AUDIT OF SHARE CAPITAL RECEIVED

Issue of shares for cash can be audited under three stages.

- Application stage
- Allotment stage
- Call stage

1. Audit at Application Stage

The auditor should vouch entries in the application and allotment book with applications received from the applicants. He should compare the entries in application and allotment book with those in cash book.

- He should ensure the deposit of application money is deposited in a scheduled bank until the certificate of commencement of business is obtained.
- He should verify amount received on application is not less than 5 percent of nominal value of share issues.
- He should vouch the amount refunded to unsuccessful applicants with copies of the letters of regret sent to them.
- He should verify whether the permission to deal in shares at stock exchange has been obtained if the prospectus mention that the application shall be made for quoting shares at a given stock exchange.
- He should check totals of all columns of application and allotment register and check the correctness of journal entries in this connection.

Following flow chart explains the audit process at the application stage.

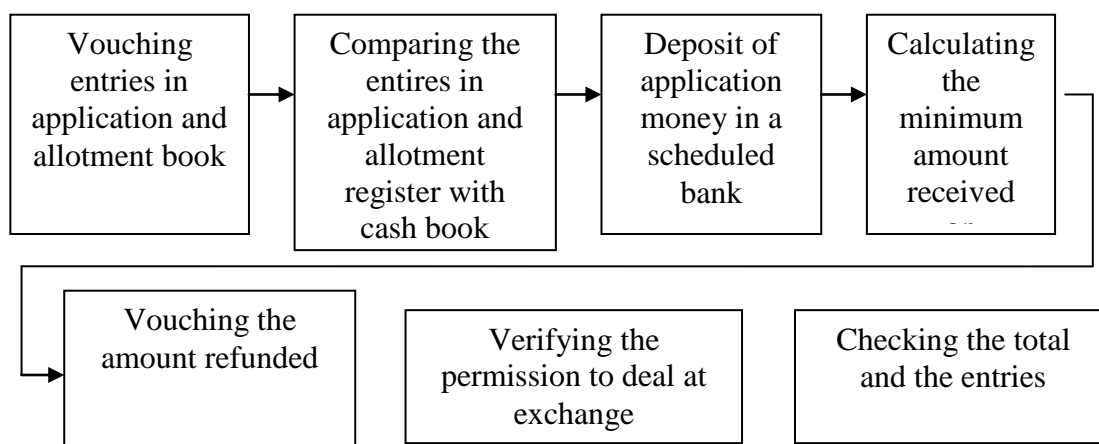


Fig 21.1 Audit process at application stage

Figure : Audit at Allotment Stage

9.2.1 Verification of allotment and money received on allotment

Audit action to be performed	Object
Reading minutes Checking Minutes book of Director's meeting.	Verifying approval for allotment
Bonafide of allotment Comparing the copies of letter of allotment and letter of regret with the entries in application and allotment book	Ensuring that allotment letter is dispatched only to originally allottees
Vouching allotment money Vouching amount received on allotment by comparing entries in the application and allotment register with cash book.	Ensuring that amount received on allotment has been banked.
Checking posting in share register checking the positing in the share register in respect of amount received on application and allotment with the totals in these two books.	Ensuring the correctness of the entry of amount received in respect of application and allotment in the share register.
Checking journals Checking the correctness of journal entries.	Ensuring amount received on allotment is booked in the respective ledger amount

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Audit at Call Stage

	Audit actions to be performed	Object
1	Minute books Auditor has to peruse Minute book of Director's meeting	Ensuring the authenticity of calls
2	Ensuring the authenticity of calls	Verifying the correctness of journal entries.
3	Verifying calls in arrears Compare the total amount due on calls as per register and actual money received as per the cash hook or bank statement.	Verifying calls in arrears.
4	Focus on share capital a/c and share call A/c	Verifying the correctness of posting the amount received in the ledger account.

Other Aspects

- Verifying filing of allotment returns with the Registrar.
- Verifying the agreement of balance of shareholders account in the share register with the totals of share capital account.
- Checking settlements of brokerage or commission as per agreement.
- Checking adherence to allotment conditions stipulated in the prospectus.
- Checking the share issue remaining within authorised capital.

4. Audit of Shares Issued for Consideration Other than cash

Audit actions to be performed	Object
Minutes books Reading the minutes of Board of Directors	To ensure the validity and the authenticity of allotment.
Contracts with vendor Thoroughly reading the contracts with vendor, promoter and underwriter	To confirm that allotment is made strictly as per the terms of contract.
Articles of association Perusing articles of association	To verify authorisation of Articles, in this regard.
Filing with register Checking the copies of return filed with the register	To make sure that return is filed within stipulated time.
Posting in share capital a/c Verifying the position in the share capital account	To ensure the correctness of journal entries posted in the ledger account.
Balance sheet disclosure verifying the balance sheet	To confirm the disclosure of shares issued for consideration other than cash in the balance sheet.

5. Issue of Shares at a Premium

Provisions of Companies Act

- Where the company collects any amount in excess of nominal value of shares, the excess is treated as premium.
- Even when shares are issued for consideration other than cash, it can be issued at premium.
- Amount equal to premium should be transferred to 'Securities Premium Account' Sec 78.
- Share premium once collected will not be refunded at the forfeiture of shares.
- Share premium account can be utilised for issuing fully paid bonus shares and for writing off preliminarily expenses, P&L a/c debit balance, underwriting commission, discount on issue of shares and debentures.

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6. Audit of Share Premium

Audit Action	Object
Checking the Articles of Association.	Checking provisions relating to share premium have been adhered to
Verifying the minutes of meeting of board of director.	To ensure that it is authorized by the Board.
Vouching cash book.	Ensuring the cash received in premium is banked.
Examining the entries in the share premium account,	Ensuring the proper posting of entries relating to share premium transaction
Checking the adherence to the guidelines issued by SEBT in connection with share premium.	Ensuring the compliance with the guidelines of SEaT.

7. Shares issued at Discount

As per section 79 of Companies Act, companies can issue shares at a discount subject to following conditions:

1. Issue should be authorised by an ordinary resolution of the company at annual general meeting.
2. The sanction of the Central Government should be obtained

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3. Maximum rate of discount is 10 percent. However higher rate above 10 percent can be considered by Central Government under special circumstance.
4. The shares should be of class already issued.
5. Carry the details of discount offered and unwritten discount paid.

Audit of Discount Issue

1. Verifying the fulfillment of aforesaid conditions.
2. Discount on issue is to be written off over a period of time. Till it is completely written off, it should appear in balance sheet under the head miscellaneous expenditure. The auditor has to verify the disclosure in this regard in the balance sheet.

8. Audit of Sweat Equity Shares

The sweat equity connotes shares issued to directors, promoters or employees at a discount or shares issued for consideration other than cash in recognition of their contribution of know-how or intellectual property rights to the company.

Conditions Stipulated for Issue of Sweat Equity

1. The shares should be of a class already issued
2. It is to be authorised by a special resolution at annual general meeting.
3. Not less than one year should have elapsed ever since the company was entitled to commence business.
4. Sweat equity of companies listed on recognised stock exchange should be issued in accordance with the regulations of SEBI. As regards companies whose shares are not listed in any stock exchange, they should be issued as per the guidelines of Central Government.

Audit Action

The auditor should confirm the fulfillment of the aforesaid conditions by the company under audit. Besides he should focus on following:

Whether equity is really sweat equity within framework of definition and explanation given II of section 79 A of Companies Act 1956.

He should familiarise himself with terms of such scheme.

Where the shares are listed ones at stock exchange, he should see that the issue conforms to the rules and regulations of SEBI. As far as unlisted shares are concerned, he should look into the guidelines prescribed by the Central Government. In India, companies issue shares under ESOP plan rather than 'under sweat equity' scheme.

9. Audit of Bonus Shares

Issue of bonus shares is one of the methods of capitalising the undistributed profits of a company. But 'Articles' should permit for issue of bonus shares. These shares are issued to the existing shareholders on a priority basis in proportion to their shareholding.

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Auditor's Duty

1. Examination of Articles of Association: He should scrutinize Articles of Association to ensure authenticity of issue of bonus shares. Where Table 'A' has been adopted, provisions contained in regulation 96 and 97 should be looked into.
2. Inspection of minute books: The auditor has to inspect Minute books of Board of Directors meeting as well as that of shareholders annual general meeting to satisfy himself that the necessary resolutions have been passed in this regard prior to the issue of bonus shares.
3. Filing copy with the Registrar: He should also see that a copy of resolution authorising issue of bonus shares has been filed with the Registrar of Companies.
4. Checking allotment book: The auditor should check whether shares have been allotted as per the details of allotment in the allotment register and to the members in the register of members.
5. Checking accounting entries: The auditor should verify the accounting entries passed in connection with bonus issue and confirm that they are in line with the legal requirements and accounting principles.
6. Adherence to SEBI guidelines: The auditor should ensure himself that SEBI guidelines pertaining to the issue of bonus shares have been observed.
7. Balance sheet: He should also examine the effect of bonus issues in the capital structure of company.

9.2.2 Verification of calls

The term 'Calls in Arrears' represent that portion of share capital which has been called up but not yet paid by the shareholder. Where a shareholder defaults in paying allotment or call moneys, the respective accounts would show debit balance to the extent of arrear. Such an amount is transferred to an account called 'calls in arrear'. This amount is shown as reduction from share capital in the balance sheet. Directors can collect interest for calls in arrears if the Articles permit from the defaulting shareholders. Where the Table 'A' has been adopted, it can charge interest at 5 percent from the due date to the date of collection or at such lower rate as may be determined by the Board.

Audit Operations

1. He should collect the list of calls in arrears.
2. The amount due from shareholders in respect of calls in arrears needs to be verified by reference to share register. The Auditor has to check whether
 - Calls in arrears due from directors should be shown separately in the balance sheet.
 - Adjustment entries in respect of interest, if any, which can be confirmed by 'virtue of Articles should be verified.
 - He should check that calls in arrears have been given effect in the balance sheet.

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AUDIT OF CALLS IN ADVANCE

A shareholder may send the amount remaining unpaid on his shares even before the call is made this voluntary payment is termed as 'calls in advance'. The amount paid in advance is adjusted towards the call money when calls are actually made. The company may pay interest if the Articles permit. Where Table 'A' has been adopted, an interest 6 percent is paid. This is the charge against profit. Such an interest can be paid out of the capital where the profits are not sufficient. The shareholder cannot claim back the amount except in the event of winding up. Such shareholders rank next to the creditor in respect of an advance. They cannot acquire voting right in respect of call money paid in advance. However, they acquire the voting right only when the call is made by the company.

Audit Operations

- The auditor should see that provisions relating to calls in advance exist in the Articles.
- He should verify that 'calls in advance' has been shown separately in the balance sheet. It should not have been shown as a part of share capital.
- He should confirm that payment of interest is made at the rates specified in the Articles.
- He should examine the amount of call in advance with the entries in the books of accounts and share register.

FORFEITURE OF SHARES

It refers to cancellation of shares by the company upon the failure of the shareholder to pay the call money despite several reminders. Following are the conditions stipulated by the Company Law to forfeit the shares.

- There should be power to forfeit shares in the Articles of Association.
- Shares can be forfeited only for non-payment of calls and not for any other sum due from the shareholders.
- Board resolution should have been passed prior to the forfeiture of shares.
- Notice reminding him to pay should have been sent to the shareholder concerned and ultimate warning that shares would be forfeited in the event of non-payment of call on or before a certain date should have been mentioned in the said notice. If there is any technical flaw in the notice, forfeiture would be rendered invalid.
- The right to forfeiture should be exercised bonafide for the benefit of the company.

Audit Operations

- The auditor should check the Articles to find out whether procedure of forfeiture has been duly followed.
- He should also look in to Minutes of the Board meeting to confirm that necessary resolution has been passed and the board has

- exercised its power in the best interest of the company
- He should verify the amount outstanding in respect of share forfeited in the light of share register.

REISSUE OF FORFEITED SHARES

Shares, after forfeiture, become the property of the company and the Directors can deal with it in any manner they like. The reissue price and amount collected prior to forfeiture should not be less than the face value of shares.

Role of Auditor

- The auditor has to verify the Article of Association to ensure that it authorises the reissue.
- He should examine the resolution of the Board in connection with the forfeiture and allotment of forfeited shares.
- The auditor should check the reissue price i.e. whether it is not less than the amount of the par value of the shares (face value).
- Where the shares are reissued at a price above the face value, the auditor should verify that excess has been transferred to the premium account.
- The auditor should vouch the entries made in respect of allotment in the cash book.
- He should see that premium collected on the reissue is credited to share premium account and not to the forfeited shares account.

Issue and Redemption of Preference Shares

After the commencement of Companies (Amendment) Act, 1996, limited companies are forbidden to issue irredeemable preference shares or any share redeemable after 20 years from the date of issue.

Auditor's Duty

- The auditor should read the Article to know whether there exists any provision to issue such shares:
- He should vouch the issue and verify the relevant records in connection therewith.
- He should vouch the receipt of issue price in terms of cash book and the share register.
- He has to examine the Minutes of the Board of Directors for verifying the matters pertaining to issue, allotment and calls.
- He has to check whether terms and conditions of redemption have been given in the share certificate.

Redemption of Preference Shares

Section 80 of the Companies Act deals with the issue of preference shares.

- Shares to be redeemed should be fully paid.
- Shares have to be redeemed either out of profits available for dividend distribution or out of fresh issue of shares.
- The premium on redemption is to be met out of the securities premium account or out of divisible profits of the company.

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- Where redemption is made out of the profits, an amount equivalent to redemption should be transferred to capital redemption reserve account.

Role of Auditor

The auditor should verify whether redemption is in line with the provisions of the Companies Act.

- He should verify the Minute books and Article where the shares are redeemed out of fresh issue.
- Where shares are redeemed out of divisible profits, he should verify the nominal value of shares redeemed to capital redemption reserve account.
- He should verify whether the company has filed with the Registrar of companies the return of redemptions
- He should see whether the entries in the cash book in this regard match with the cancelled share certificates.
- He should confirm that premium payable on redemption was provided for either out of share premium account or out of divisible profits of the company.
- He should vouch the payment made to preference shareholders on redemption with the 'bank statement' and 'receipts' issued to the shareholder and other documentary evidence.

9.3 ALTERATION OF CAPITAL

A company having a share capital can alter its share capital.

- If it is authorized by Articles
- Provided special resolution is passed

Forms of Alteration

- Increase in the share capital by fresh issue.
- Conversion of fully paid shares into stock or vice versa.
- Subdivision of shares into small amount.
- Consolidation of and division of all or any of its shares into shares of higher denomination.
- Cancellation of shares not taken up by the public and diminishing the amount of shares so cancelled.

Audit Procedure

- The auditor has to examine whether the Articles permit the alteration.
- He has to see that the procedure prescribed in the Article is duly observed.
- He has to confirm that the provisions of section 94 of the Companies Act have been complied with.
- He should scrutinise the Minute books of shareholders meeting to confirm the authorisation for alteration.
- He should look into Minute books of Director's meeting adopting shareholder's and Director's resolutions in this regard to allotment subdivision, consideration and cancellation.

- He should verify the correspondence of the company with the Registrar of companies in this regard.
- He should see whether the altered share capital is shown in the balance sheet.
- He should see the certificate issued by the Registrar approving altered capital.
- He should match the cancelled share certificate if any, with the counter foils of new share certificate issued.
- He should check the correctness of journal entries passed in connection with the alteration of share capital.
- He should obtain a list of allotment of shares including holdings, or shares or stock of each member and vouch it with the entries in the cash book.

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9.4 CHECK YOUR PROGRESS

1. What is auditors duty in connection with transmission of shares.
.....
2. How would you audit calls in advance?
.....
3. State the procedure an auditor should follow to verify the issue of shares for cash and consideration other than cash?
.....
4. Bring out the role of auditor in alteration of capital?
.....
5. State conditions for altering the capital of a company.
.....

9.5 SUMMARY

Statutory auditor has to focus on share capital items with regard to the truth and fairness of available information. He should ensure that the provisions of Act like company act 1956 and SEBI ACT 1992 with regard to capital are not violated. In this content audit of share capital assumes a singular significance. The share capital is undertaken both at the inception phase as well as at later phases when emergent capital are raised.

9.6 KEY WORDS

Share audit: Audit of share capital transactions of a corporate entity is called share audit.

Reserve capital : This is the uncalled capital which can be called upon except at the time of winding up of company

Secure reserve : Reserve which are not disclosed the balance sheet are called secure reserve.

Human resource audit-It is an examination of Human assets figure that appear in the balance sheet through checking based on the estimated value of human assets.

UNIT X BRANCH AUDIT

Branch Audit

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- 10.0 Introduction
- 10.1 Objectives
- 10.2 Branch Audit
- 10.3 Special Audit
- 10.4 Joint Audit
- 10.5 Continuous Audit
- 10.6 Statutory Audit
- 10.7 Management Audit
 - 10.7.1 Objectives
 - 10.7.2 Advantages of Management Audit
- 10.8 Self assessment questions
- 10.9 Summary
- 10.10 Key words

10.1 INTRODUCTION

In a case the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under sub-section (1) of Section 148 and which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order.

Provided that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

a. The cost auditor shall forward his report to the Board of Directors of the company within a period of 180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

b. Every company covered under these rules shall, within a period of 30 days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in form CRA-4.

10.2 OBJECTIVES

It throw light on different types of Audit

10.2 BRANCH AUDIT

Section 2(9) of Companies Act defines branch office as:

Any establishment described as a branch by the company. Any organisation carrying on same or substantially same activities carried on by head office -

Any establishment engaged in productive processing or manufacture, U/S 228(1) either the company auditor or any other person qualified for appointment as auditor can be engaged as branch auditor.

Appointment

Branch auditors are appointed at the annual general meetings by shareholders or by Board of directors in consultation with company auditor. The terms and conditions of appointment and remuneration are fixed by the appointing authority.

Company auditor and branch auditor

As per Standard Accounting Practices (SAP) 10, principal auditor can rely on the report of the branch auditor. However, he may visit the branch office and probe the accounts where circumstances warrant it.

Provisions of the Companies Act, 1956 relating to Branch Audit

The points to be considered by an auditor as regards branch audit as per section 228 are as follows:

Where a company has a branch office, the accounts of that office must be audited by the company's auditor appointed under Section 224 or by a qualified person other than the company's auditor.

If the branch office is situated in a foreign country, the accounts must be audited by the company's auditor or by a qualified person or by an accountant qualified to act as an auditor in accordance with the law of that country.

In case the accounts of a branch are audited by a person other than the company's auditor, the company's auditor has

- the right to visit the branch, if he considers it necessary, for the purpose of his duties and
- the right of access at all time to the books and accounts and vouchers maintained at the branch office.
- the right of access to the copies of the books and accounts of the branch of a bank located outside India which have been sent to the head office of the company in India.

Exemption from Audit

If a company in general meeting decides to have the accounts of its branch office audited by a person other than the company's auditor, the company will appoint in that meeting a qualified person to audit its branch.

In case the branch office is situated in a foreign country, the company will, in that meeting, appoint a person either qualified under Section 226 of the Companies Act or qualified to act as an auditor under the law of that country. Instead of appointing a person to audit its foreign branch, the company in general meeting may also authorise the Board of directors to appoint an auditor in consultation with the company's auditor.

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The branch auditor so appointed shall have the same powers and duties as the company's auditor in respect of his head office. He must prepare a report on the accounts of the branch office audited by him and send the same to the company's auditor. -

The branch auditor is entitled to receive remuneration for his work and will hold office subject to such terms and conditions as may be fixed by the company in general meeting or by the Board of directors, if so authorised by the company in general meeting.

The Central Government is empowered to make rules for exempting any branch office from compulsory audit.

- i. Whether the company has made arrangement for the audit of the accounts of its branch by an officer or an employee of the company who is qualified to act as an auditor.
- ii. Whether the nature and quantum of activity carried on at the branch office for the immediately preceding three years justifies an audit.
- iii. Whether qualified auditors are available at a reasonable cost for branch audit. —
- iv. Whether there is any other ground justifying grant of exemption from compulsory audit.

The Company's auditor must pay special attention to the following items

- i. Whether the returns forwarded to him contain full details of sales, purchases various items of receipts and payments and assets liabilities.
- ii. Whether stock-in-trade has been valued according to the accepted principle of accountancy.
- iii. Whether bad and doubtful debts have been provided for.
- iv. Whether the branch bank balance has, been verified by the branch auditor by getting a confirmation from the bank.
- v. Whether depreciation has been provided for fixed assets.
- vi. Whether the balance shown by the branch has been converted into home currency correctly.
- vii. After carefully examining the report of the branch auditor, he has to incorporate it in his audit report to be placed before the shareholders at the annual general meeting.
- viii. He also has to report whether a report on the accounts of the branch office audited by a person other than the company's auditor has been sent to him as required by Companies Act and also how he has dealt with the same in preparing his report.
- ix. If any exemption has been granted to the company from the compulsory audit of its branch, the auditor should also state this in his report.

10.3 SPECIAL AUDIT

Circumstances necessitating Special Audit

The Central Government has power under Section 238-A of the Companies Act to conduct a special audit of a company's accounts. It may direct the special audit when:

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- the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices or
- the company is managed in a manner likely to damage the interest of the trade, industry or business or
- the financial position of the company is such as to endanger -its solvency.

Appointment of a special Auditor

The Central Government will appoint

- a chartered accountant whether in practice or not or
- the company's auditor himself to conduct such special audit.

The special audit may cover such period as the Central Government specifies. The auditor so appointed in this connection is known as auditor.

Powers

The special auditor will have the same powers and duties as company auditor. The Central Government shall direct any person specified in the order to furnish to the special auditor any information called for by him connection with the special audit. Failure to comply with such order will result in punishment with fine up to Rs.500.

The report will include all matters required to be included in auditor's report under Section 227. The Central Government may also direct that the report should include a statement on any other matter referred to him in that order. The special auditor after completing his work should submit the report to Central Government and not to the members of the company.

Follow-up action on the special audit report

On receipt of the report of the special auditor, the Central Government may take such action on the report as it considers necessary.

If the Central Government does not take any action on the report within four months from the date of its receipt, it will send to the company either a copy of the report or of the relevant extracts from the report with its comments. It will ask the company either to circulate the copy of the report amongst the members or to have them read at its general meeting.

Remuneration of a special auditor

The remuneration of a special auditor including all expenses incidental to the conduct of the special audit will be fixed by the Central Government and paid by the company.

General duties of a special auditor

The special auditor should first note the precise nature of the inquiry from the government. He has to follow the procedure adopted for the audit of the company's account. He should be very careful and painstaking in his work as he has to certify whether or not the company's

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affairs are being managed in accordance with sound business principles or prudent commercial policy. He should go beyond what is revealed by the account. He should make a thorough probe into the policies followed by the company in all matters.

10.4 JOINT AUDIT

Where two or more auditors are engaged where the transactions are voluminous or the size of the firm is large, it is called joint audit.

ICAI has issued a statement on the responsibilities of joint auditors accordingly the responsibilities of joint auditors are enumerated below:

- Joint auditors should discuss about the nature of work and mutually divide the work between them in terms of branch, department, etc.
- The area of work should be documented and communicated.
- The matters that deserve the attention of other joint auditor, which are relevant, which require disclosure, discussion and judgement may be communicated in writing.
- Auditors are jointly and severally liable in respect of work not divided among the joint auditors, decisions jointly arrived at, matters brought to the notice of any one of the joint auditors, financial statement that comply with disclosure requirements and audit report that complies with requirements of the relevant statute.
- Each joint auditor is specifically responsible for the area of work allocated to him; internal control system related to the work allocated, nature and timing and the extent of enquires to be made during the audit, visit of branch falling within his area of work, obtain the information and explanation in respect of work assigned to him.
- Where the joint auditors differ in their opinion to be included in the report, both have to give separate reports.

10.5 CONTINUOUS AUDIT

Under continuous audit each and every transaction of the business is checked by the Auditor regularly. Continuous audit is required in large organizations where number of transactions is very high, internal control system is not effective, periodicals statements are required and final accounts are prepared immediately after the close of financial years like banks.

Advantages – Complete checking of records, up-to-date accounts, moral-check on staff and early finalization of financial statements are the main advantages of continuous audit.

Disadvantages – High cost of continuous audit, mechanical work of Auditor, chances of unhealthy relations with staff due to frequent visits, etc., are main disadvantages of continuous audit.

10.6 STATUTORY AUDIT

Where the appointment of a qualified Auditor is compulsory as per the law is called as a statutory audit. The following are the essential characteristics of statutory audit –

- An Auditor must be a qualified accountant.
- Norms of the appointment of Auditor are provided by the law. Rights, duties and liabilities of an Auditor are as defined by the statute; management cannot make any changes in it.
- Organization cannot restrict the scope of statutory audit.
- Statutory audit provides true and fair view of financial position to shareholders and members of an organization. It helps the shareholders to keep themselves protected from any fraud and misrepresentation.
- Statutory audit is a compulsory audit. Auditor is an independent person and management doesn't have any control over his work.

Following stakeholders are covered under the statutory or compulsory audit.

10.7 MANAGEMENT AUDIT

Efforts are done to bring out an overall improvement in management efficiency through review of all the objectives, policies, procedures and functions of management. Only a person having good knowledge and experience of management techniques may be appointed as Management Auditor.

10.7.1 Objectives

Following are the main objectives of management audit –

- To help management in setting sound objectives.
- To ensure the fulfilment of objectives.
- To give recommendation about change in policies and procedure for better results.
- To help management in elaborating duties, rights and liabilities of the employees.
- To help management in establishing good and sound relation with outsiders.

10.7.2 Advantages of Management Audit

- It is helpful in making plan, objectives and policies of the management.
- It is helpful to efficiently achieve the set objectives of the management by coordinating with the personnel.
- It is very helpful to create strong communication system with outsiders and within the various departments.

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- It is helpful to evaluate the performance of management.
- To establish good relations with employees.
- To elaborate duties, rights and liabilities of staff members and to make market strategies.
- It is helpful in preparation of budgets of organizations.
- It is helpful in preparation of budgets.
- It is helpful in resource management.

Criticism of Management Audit

In spite of the various advantages of management audit in modern business world, it has faced criticism too

- According to managers and accountant it is just a vague concept which serves no material purpose at all.
- Management Auditors usually pin point shortcomings of managers in action, therefore they hesitate to take initiative.
- Normal practice of managers is to keep their record up to date instead of improving efficiency and reducing costs.

10.8 CHECK YOUR PROGRESS

1. What are the power of special audit.
.....
2. Sate the exemption for branch audit.
.....
3. Explain the duties of the special auditor.
.....
4. Mention the circumstance under which special audit is conducted.
.....
5. Discuss the merit and drawbacks of continuous audit.
.....

10.9 SUMMARY

The audit of a joint stock company is intended for the protection of the shareholders and the auditor is experted to examine the accounts maintained by the directors with a view is informing the shareholders of the true financial position of the company.

10.10 KEY WORDS

Standard Audit-under this audit, certain items in the account are throughly checked and analyzed and appropriate test chcke are applied. to other items provided there is a good internal check system.

Proprietary audit : Proprietary audit is clefined as an appraisal of rightness of executive action and plans.

Audit memorandum: It is a statement containing all useful information regarding the business of a clinet. It indicate the method of operation policies of different aspects of the business as well a conetion in respect of audit.

Branch Audit

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UNIT XI COST AUDIT

Cost Audit

NOTES

- 11.0 Introduction
- 11.1 11.1 Objectives:
- 10.2 Appointment Of Cost Auditor: Procedure
 - 10.2.2 Powers of a COST AUDITOR
- 10.3 Auditing with the computer
- 10.4 Self Assessment questions
- 10.5 Summary
- 10.6 Keywords

11.0 INTRODUCTION

The scope of Audit is no more restricted to financial audit under companies act. It extends to cost accounts.

11.1 OBJECTIVES

How the cost auditors verify the comates of accounts.

11.2 APPOINTMENT OF COST AUDITOR: PROCEDURE

The category of companies specified in rule 3 and the thresholds limits laid down in rule 4 of Companies (Cost Records and Audit) Rules, 2014, shall within one hundred and eighty days of the commencement of every financial year, appoint a cost auditor

1. The audit committee, if constituted by the company shall ensure that the cost auditor is free from any disqualifications.
2. The audit committee shall obtain a certificate from the cost auditor certifying his independence.
3. Every company referred to in sub-rule (1) shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in form CRA-2, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014
4. On filing the application, the same shall be deemed to be approved by the Central Government, unless contrary is heard within 30 days from the date of filing of such application
5. If within thirty days from the date of filing of such application, the Central Government directs the company to re-submit the said application with additional information the period of thirty days for deemed approval of the Central Government shall be counted from the date of re-submission by the company.
6. After the expiry of thirty days, the company shall issue formal letter of appointment to the cost auditor.

7. The audit committee, if constituted by the company recommends to the Board a suitable remuneration to be paid to the cost auditor. In the case of those companies which are not required to constitute an audit committee, the Board shall consider and approve the remuneration of the Cost Auditor which shall be ratified by shareholders subsequently.
8. Every cost auditor appointed as such shall continue in such capacity till the expiry of one hundred and eighty days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.
9. Every cost auditor, who conducts an audit of the cost records of a company, shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in form CRA-3
10. Every cost auditor shall forward his report to the Board of Directors of the company within a period of one hundred and eighty days from the closure of the financial year to which the report relates and the Board of directors shall consider and examine such report particularly any reservation or qualification contained therein
11. Every company covered under these rules shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report alongwith full information and explanation on every reservation or qualification contained therein, in form CRA-4 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.
12. The company shall disclose full particulars of the cost auditor, along with the due date and actual date of filing of the cost audit report by the cost auditor, in its Annual Report for each relevant financial year
13. In those companies, where constitution of Audit Committee is not required by law, then the role of Audit Committee shall be discharged by the Board of Directors.
14. in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.' the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders; the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor; in the case of companies which are required to constitute an audit committee-

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11.2.2 POWERS OF A COST AUDITOR

1. He should submit his Cost Audit Report to the Central Government within one hundred and eighty days from the end of the company's financial year to which such report relates, and a copy of the said report to the company.
2. He should clearly state, in his report, that: a. He has obtained all the information and explanations relating to the cost accounts which to the best of his knowledge and belief were necessary for the purposes of the cost audit. b. Proper cost accounting records as required under the relevant Cost Accounting (Records) Rules have been kept by the company.
3. The books and records kept by the company give the information in the manner required by the Companies Act
4. He should keep records of various errors or omissions and commissions done by the client staff
5. He should understand and appraise the company's policies and procedures and systems adopted for the purpose of controlling wastages and inefficiencies.
6. He should see and ensure what other exceptional duties are cast upon him by the Articles of the company.
7. Lastly, he has a continuing duty to maintain his professional knowledge and skill at a level conducive to act as a cost auditor competently.

Internal controls in a computer environment

The two main categories are application controls and general controls.

Application controls

These are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records.

Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorised and are completely and accurately recorded and processed (ISA 315 (Redrafted)).

Application controls apply to data processing tasks such as sales, purchases and wages procedures and are normally divided into the following categories:

- (i) Input controls Examples include batch control totals and document counts, as well as manual scrutiny of documents to ensure they have been authorised. An example of the operation of batch controls using accounting software would be the checking of a manually produced figure for the total gross value of purchase invoices against that produced on screen when the batch-processing option is used to input the invoices. This total could also be printed out to confirm the totals agree.

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

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

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

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

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

(iv) Master files and standing data controls Examples include one-for-one checking of changes to master files, eg customer price changes are checked to an authorised list. A regular printout of master files such as the wages master file could be forwarded monthly to the personnel department to ensure employees listed have personnel records.

General controls

These are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, mini-frame and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- data centre and network operations
- system software acquisition, change and maintenance
- program change
- access security
- application system acquisition, development, and maintenance (ISA 315 (Redrafted))

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‘End-user environment’ refers to the situation in which the users of the computer systems are involved in all stages of the development of the system.

(i) Administrative controls

Controls over ‘data centre and network operations’ and ‘access security’ include those that:

- prevent or detect errors during program execution, eg procedure manuals, job scheduling, training and supervision; all these prevent errors such as using wrong data files or wrong versions of production programs
- prevent unauthorised amendments to data files, eg authorisation of jobs prior to processing, back up and physical protection of files and access controls such as passwords
- ensure the continuity of operations, eg testing of back - up procedures, protection against fire and floods.

(ii) System development controls

The other general controls referred to in ISA 315 cover the areas of system software acquisition development and maintenance; program change; and application system acquisition, development and maintenance.

‘System software’ refers to the operating system, database management systems and other software that increases the efficiency of processing. Application software refers to particular applications such as sales or wages. The controls over the development and maintenance of both types of software are similar and include:

- Controls over application development, such as good standards over the system design and program writing, good documentation, testing procedures (eg use of test data to identify program code errors, pilot running and parallel running of old and new systems), as well as segregation of duties so that operators are not involved in program development
- Controls over program changes – to ensure no unauthorised amendments and that changes are adequately tested, eg password protection of programs, comparison of production programs to controlled copies and approval of changes by users
- Controls over installation and maintenance of system software – many of the controls mentioned above are relevant, eg authorisation of changes, good documentation, access controls and segregation of duties.

Exam focus

Students often confuse application controls and general controls. In the June 2008 CAT Paper 8 exam, Question 2 asked candidates to provide examples of application controls over the input and processing of data. Many answers referred to passwords and physical access controls – which are examples of general controls – and thus failed to gain marks.

Computer-assisted audit techniques

Computer-assisted audit techniques (CAATs) are those featuring the ‘application of auditing procedures using the computer as an audit tool’ (Glossary of Terms). CAATs are normally placed in three main categories:

(i) Audit software

Computer programs used by the auditor to interrogate a client’s computer files; used mainly for substantive testing. They can be further categorised into:

- Package programs (generalised audit software) – pre-prepared programs for which the auditor will specify detailed requirements; written to be used on different types of computer systems
- Purpose-written programs – perform specific functions of the auditor’s choosing; the auditor may have no option but to have this software developed, since package programs cannot be adapted to the client’s system (however, this can be costly)
- Enquiry programs – those that are part of the client’s system, often used to sort and print data, and which can be adapted for audit purposes, eg accounting software may have search facilities on some modules, that could be used for audit purposes to search for all customers with credit balances (on the customers’ module) or all inventory items exceeding a specified value (on the inventory module).

Using audit software, the auditor can scrutinise large volumes of data and present results that can then be investigated further. The software consists of program logic needed to perform most of the functions required by the auditor, such as:

- select a sample
- report exceptional items
- compare files
- analyse, summarise and stratify data.

The auditor needs to determine which of these functions they wish to use, and the selection criteria.

Exam focus Sometimes, questions will present students with a scenario and ask how CAATs might be employed by the auditor. Question 4 in the December 2007 Paper F8 exam required students to explain how audit software could be used to audit receivables balances. To answer this type of question, you need to link the functions listed above to the normal audit work on receivables. Students should refer to the model answer to this question.

The following is an example of how this could be applied to the audit of wages:

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- Select a random sample of employees from the payroll master file; the auditor could then trace the sample back to contracts of employment in the HR department to confirm existence
- Report all employees earning more than \$1,000 per week
- Compare the wages master file at the start and end of the year to identify starters and leavers during the year; the auditor would then trace the items identified back to evidence, such as starters' and leavers' forms (in the HR department) to ensure they were valid employees and had been added or deleted from the payroll at the appropriate time (the auditor would need to request that the client retain a copy of the master file at the start of the year to perform this test)
- Check that the total of gross wages minus deductions equates to net pay.

(ii) Test data

Test data consists of data submitted by the auditor for processing by the client's computer system. The principle objective is to test the operation of application controls. For this reason, the auditor will arrange for dummy data to be processed that includes many error conditions, to ensure that the client's application controls can identify particular problems.

Examples of errors that might be included:

- supplier account codes that do not exist
- employees earning in excess of a certain limit
- sales invoices that contain addition errors
- submitting data with incorrect batch control totals.

Data without errors will also be included to ensure 'correct' transactions are processed properly.

Test data can be used 'live', ie during the client's normal production run. The obvious disadvantage with this choice is the danger of corrupting the client's master files. To avoid this, an integrated test facility will be used (see other techniques below). The alternative (dead test data) is to perform a special run outside normal processing, using copies of the client's master files. In this case, the danger of corrupting the client's files is avoided – but there is less assurance that the normal production programs have been used.

(iii) Other techniques There are increasing numbers of other techniques that can be used; the main two are:

- Integrated test facility – used when test data is run live; involves the establishment of dummy records, such as departments or customer accounts to which the dummy data can be processed. They can then be ignored when client records are printed out, and reversed out later.
- Embedded audit facilities (embedded audit monitor) – also known as resident audit software; requires the auditor's own program code to be embedded into the client's application software. The embedded code is designed to perform audit functions and can be switched on at

selected times or activated each time the application program is used. Embedded facilities can be used to:

- Gather and store information relating to transactions at the time of processing for subsequent audit review; the selected transactions are written to audit files for subsequent examination, often called system control and review file (SCARF)
- Spot and record (for subsequent audit attention) any items that are unusual; the transactions are marked by the audit code when selection conditions (specified by the auditor) are satisfied. This technique is also referred to as tagging.

The attraction of embedded audit facilities is obvious, as it equates to having a perpetual audit of transactions. However, the set-up is costly and may require the auditor to have an input at the system development stage. Embedded audit facilities are often used in real time and database environments.

10.3 AUDITING WITH THE COMPUTER

The fact that systems are computer-based does not alter the key stages of the audit process; this explains why references to the audit of computer-based systems have been subsumed into ISAs 300, 315 and 330.

- (ii) Planning The Appendix to ISA 300 (Redrafted) states ‘the effect of information technology on the audit procedures, including the availability of data and the expected use of computer - assisted audit techniques’ as one of the characteristics of the audit that needs to be considered in developing the overall audit strategy.
- (iii) Risk assessment 'The auditor shall obtain an understanding of the internal control relevant to the audit.' (ISA 315 (Redrafted))

The application notes to ISA 315 identify the information system as one of the five components of internal control. It requires the auditor to obtain an understanding of the information system, including the procedures within both IT and manual systems. In other words, if the auditor relies on internal control in assessing risk at an assertion level, s/he needs to understand and test the controls, whether they are manual or automated. Auditors often use internal control evaluation (ICE) questions to identify strengths and weaknesses in internal control. These questions remain the same – but in answering them, the auditor considers both manual and automated controls.

For instance, when answering the ICE question, ‘Can liabilities be incurred but not recorded?’, the auditor needs to consider manual controls, such as matching goods received notes to purchase invoices – but will also consider application controls, such as programmed sequence checks on purchase invoices. The operation of batch control totals, whether programmed or performed manually, would also be relevant to this question.

(iii) Testing ‘The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.’ (ISA 330 (Redrafted))

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11.4 CHECK YOUR PROGRESS

1. Explain the powers of cost auditor.

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2. Explain the administration and procedural control.

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11.5 SUMMARY

This statement holds true irrespective of the accounting system, and the auditor will design compliance and substantive tests that reflect the strengths and weaknesses of the system. When testing a computer information system, the auditor is likely to use a mix of manual and computer-assisted audit tests

11.6 KEYWORDS

Substantive test: A substantive test of a transition or balance which seeks to provide audit evidence as to competences accuracy and validity of information contained in the accounting recurred.

Surprise checking

Surprise checking means audit verification on a non-routine and surprise basis in order to uncover an ingenious fraud and errors.

UNIT XII AUDIT OF SPECIAL INSTITUTION AND INVESTIGATION

Audit of Special Institution and Investigation

NOTES

- 12.0 Introduction
- 12.1 Objective
- 12.2 12.2 Role of an auditor on verification of report
 - 12.2.1 Audit of Hotels
 - 12.2.2 Audit of Clubs & Theatre
 - 12.2.3 - Audit of Hospitals
- 12.3 Self assessment questions
- 12.4 Summary
- 12.5 Key words

12.0 INTRODUCTION

Every audit is special in the sense that it has its distinct features. Audit for different institutions warrant specialized knowledge from an auditor. The following chapter illustrates the specialized audit

12.1 OBJECTIVE

It enlightens the students on audit of special institutions.

12.2 ROLE OF AN AUDITOR ON VERIFICATION OF REPORT

In this chapter, we will discuss the Audit of Hotels.

There are many types of facilities that are provided by the hotels to their customers these days. Hotels generate their income from room rent, room service, laundry, restaurants, swimming pool, bar-room, sports room, health clubs, conference halls and banquet hall for marriages, parties and seminars. In addition to these, few hotels are also letting out shops to companies to promote and sell their products and services.

12.2.1 Audit of Hotels

An Auditor should consider the following points while conducting Audit of Hotels –

Detail of Applicable Law

For audit of hotels, it is very crucial and important for an Auditor to go through the following laws normally applicable to the hotel industry –

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List of Applicable Law	Subject	Levy On
Luxury Tax Act	State Act	Room Rent for luxury provided
Service Tax	Central Act	On Restaurants, Dry-cleaning service, Banquet revenue and room rent Note – Service Tax on room rent and restaurant are charged on some specific conditions.
State Excise Act	State Act	On liquor and regulated sale/service of liquor.
Food safety & Standard Act, 2006. Prevention of Food Adulteration Rules, 2010	Central Act	For hygiene and quality of food
Central Excise Act	Central Act	On pastries and cakes.
Value Added Tax (VAT)	State Act	On food and other goods.
Standards of Weight and Measures Act, 1976	Central Act	To establish standards of weight and measures.
Contract Labour (Regulation and Abolition) Act	Central Act	On employing contract labor.
Shops and Establishment Act and the Catering Establishments Act	State Act	To regulate the working of hotels.

The Companies Act, 2013 may also be applicable to hotels in case if the status of hotel is like a company. Whereas, the Income Tax Act, 1961 will be levied in all the cases irrespective of whatever the status of that hotel is.

- An Auditor should determine the scope of his audit from his letter of appointment. It should be seen whether he is asked to express his opinion on financial statements only or some additional responsibility being assigned to him.
- An Auditor should obtain list of books of accounts, documents and registers maintained by hotel.
- He should see whether relevant hotels have independent status or a part of chains of hotels.
- An Auditor should study the Memorandum of Articles and the Memorandum of Association.

- He should obtain the title deed and other related documents to verify the land and building.
- He should also obtain Minutes of meeting of the Board of Directors to note down the important decisions relating to accounts, finance and audit.

Point of Sale (POS)

In order to conduct audit of a hotel, an Auditor should study, verify and vouch books of accounts, keeping in mind the different points of sale.

Points of Sale

Let us now understand the different points of sale.

Revenue from Room Rent

An Auditor has to carefully examine the following points regarding revenue from room rent –

- One of the main revenue generation points in hotel industry is room rent. The billing is done through accounting software (most of the hotels are using PMS software which is very popular in hotel industries).
- Room rent is charged on the basis of fixed tariff according to the category of room.
- Discounts may be offered to customers; this depends on various factors like season, holidays and other things. Special discount is also offered to groups of students, delegates, corporate customers, VIP customers, etc.
- Complementary rooms are provided by hotels for some special guests and hotel staff.
- An Auditor has to get the structure of discount and he should also ensure that the discount offered is within permissible limit or not. Authorization from appropriate authority should be done on discounts.
- An Auditor should verify the Luxury Tax on the room rent charged. In some states, the Luxury Tax is charged on actual room revenue received from the customers and in some states it is chargeable on the published rack rate.
- In most of the states, Luxury Tax is chargeable on complementary rooms also.
- Exemption on Luxury Tax is provided in case where complementary rooms are provided to the hotel staff.
- An Auditor has to verify that all collected Luxury Tax is deposited with state within time.
- He should verify the retention charges which are collected from customers due to either cancellation of a reservation or due to non-arrival upon reservation.

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- An Auditor should verify applicable law of Luxury Tax regarding retention charges; in a few states, Luxury Tax is applicable on retention charges also.

Revenue from Food & Beverages (Restaurants)

The following points need to be considered by an Auditor to examine the revenue coming from Food and Beverages in Restaurants –

- There are two types of sale at restaurants; one is to the resident customer and the second is to walk-in customers.
- An Auditor should verify that the sale to resident customer is recorded in the combined bill and a cash receipt is issued in case of sale to walk-in customers.
- VAT should be charged on the bill as per applicable rate.
- Service Tax is also chargeable as per applicable rate on food bills in case where the restaurant is air-conditioned and restaurants providing liquor to customers. An Auditor should verify the amount of VAT and Service Tax according to the applicable rate.
- An Auditor should examine that all collected VAT and Service Tax have been deposited with government within time or not.

Revenue from Food & Beverages (Room Service)

The Revenue from the sale of Food and Beverages through room service is also a very common feature and an Auditor should consider the following and verify the revenue –

- All generated bill should be accounted for in the main bill of the resident customer.
- An Auditor should examine the KOT (Kitchen Order Ticket) to verify the F&B bills.
- Applicable VAT and Service Tax should be charged on bills.
- An Auditor should verify the rate of service charges if any applicable on F&B bills.

Food & Beverages Revenue from Minibar

Food & Beverages Revenue from Minibar The revenue from the food and beverages from the minibar also needs to be verified by the Auditor; the following points need to be considered for the same.

- Most hotels keep minibar stocked with liquor, soft drinks and snacks, etc.
- Billing of these items is based on self-declaration by the Guest through filling up of the form kept in the minibar.
- The minibar attendant checks the consumption and bills.
- The Auditor should verify the daily report of consumptions and stock of these items and should match with the billing to guest.

Revenue from Banquets

An Auditor needs to consider the following points and verify the revenue from Banquets –

- Normally, rate offered is a composite rate for food and beverages and rent of hall.
- Composite rate as above is based on per person.
- If actual cover (means per person) is less than the contracted rate, billing is done on minimum guaranteed covers. For example, banquet rent including F&B is Rs. 1,00,000/- for 100 persons and the per person rate is Rs. 1,000/-..
 - If the actual number of persons is 90, then the hotel will charge Rs. 1,00,000/- at the minimum guaranteed rate.
 - If the actual number of persons is 120, then the hotel will charge Rs. 1,00,000 + 1,000 x 20 = 1,20,000/-.
- Service Tax and VAT both are chargeable on composite rate.
- If the rent of banquet hall and the F&B charges are separate, Service Tax and VAT will be charged accordingly.

Revenue from Business Centre

An Auditor needs to consider the following points and verify the revenue from Business Centre –

- Business centre services means meeting room, fax service, photocopy service and secretarial services, etc.
- An Auditor should carefully examine the business centre services because these services are manually tracked to billing; if manual tracking through appointment register is missed, billing will be omitted.

Arcade Revenues

An Auditor needs to consider the following points and verify Arcade Revenues –

- Hotels provide shopping space at a fixed monthly rent at lobby of hotel or any other public area.
- An Auditor should verify the rent deed, contract deed, cash book, bank book, cash receipt counter foil to verify this revenue.

Revenue from Car Hire

An Auditor needs to consider the following points and verify the Revenue from Car Hire –

- Car facility is provided by hotels to their guest through dedicated travel agencies.
- Whenever guests hire cars, charges are posted to the guest folio.
- A hotel gets commission from travel agency which is based on the charges earned by the travel agency.

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- An Auditor should examine the bills issued to customers and the amount paid to the travel agencies.

Revenue from Telephone & Internet

An Auditor needs to consider the following points and verify the Revenue from Telephone and Internet –

- Telephone bills are charged through EPABX system and internet service is charged through internet service providing system.
- For internet charges, Service Tax is charged.
- In some states like Kerala, Luxury Tax is charged on telephone bills.

Revenue from Housekeeping

This revenue is normally charged for sale of wardrobes and baby-sitting, etc.

Revenue from Laundry

An Auditor needs to consider the following points and verify the revenue from Laundry –

- Laundry service is provided to employees of hotel and resident guests.
- Billing is done through accounting software according to the rate provided.
- An Auditor should get the rate list to verify the rates and the billing should be verified with the housekeeping record.

Revenue from Beauty Parlors and Health Clubs

An Auditor needs to consider the following points and verify the Revenue from Beauty Parlors and Health Clubs –

- These facilities are provided to resident guests, walk-in guests or through membership.
- An Auditor should verify the rate charged for service provided and guest attendance register.
- He should ensure the all services should be charged and recovered from customers.

Revenue from Sale of Scrap and Disposal of Empties

An Auditor needs to consider the following points and verify the Revenue from Sale of Scrap and Disposal of Empties –

- Scrap and empties can be sold on the basis of contract price or on the basis of onetime evaluation at the time of sale.
- An Auditor should verify the agreement for contract price in case where there is a time bound agreement between hotels and scrap buyer.
- Sale of dry scrap is also very important in hotels like sale of empty cans, bottles and other containers.

- He should verify the outward register, weighing slips, etc. and the rate charged for the same.
- An Auditor should verify the cash receipt & cash book, etc.

Audit of Expenses

An Auditor needs to consider the following points and verify the Revenue from Expenses –

- An Auditor should verify the appointment letter, policy of increment, time record, salary register, cash book and bank book to verify the salary payments of employees.
- He should verify all purchases through requisition slip, quotations, purchase order, inward register, quality control verification record and stock ledger.
- Every purchase should be passed by appropriate authority in this regard.
- Vouching should be done properly and should be verified with documentary evidences.
- At times, there may be a contract between a seller and a buyer (hotel) to sell a particular product at the same rate for a specific period like a week or a month, especially in case where the supply of material is done on daily basis like milk, bakery products, fresh vegetables, etc. The Auditor should verify purchases on the basis of such agreement.
- An Auditor should apply all other precautions and experience to audit the expenses as he does in any other industries.
- Verification of purchases, consumption and stocking is very crucial in hotel industry and it is a real challenge for an Auditor to verify all these very carefully. An Auditor should apply all his experience and knowledge to do audit of it.

12.2.2 Audit of Clubs & Theatre

In this chapter, we will discuss the Audit of Clubs and Theatre.

Audit of Clubs

The following points need to be considered while conducting Audits of Clubs –

- An Auditor should decide his scope of work from his appointment letter.
- He should know whether he is engaged for only accounting and financial matter or some other assignment too.
- He should know about the constitution and the legal status of the Club under which Act the club is registered.
- A Club may be registered under the Companies Act, the Societies Registration Act or the Public Trust Act.

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- An Auditor should note down all the related provisions of the applicable Act relating to the accounts and audit.
- He should study the Memorandum of Association and the Articles of Association to know the powers of executive committee.
- An Auditor should be aware of the important decisions relating to accounts, finance, sale and purchase of fixed assets and investment from the minute book of meeting of the Board of Directors or the Trustees or the Managing Committee.
- He should obtain a list of books of accounts, related documents and other records maintained by that club.

Internal Control System

An Auditor should review the internal control system of Club to conclude on the effectiveness of it and to decide the area and scope of his work.

- He should study the letting out system of the club premises, equipment and other facilities.
- The Auditor should know the bills raising system.
- He should study the rate and the basis of guest house charges, temporary membership charges, eatables, sports equipment.
- If Auditors find that the internal control system is adequate in club, he may opt for test checking, otherwise he might have to go for detailed vouching.

Audit of Income and Expenditure of Club

In addition to the general procedure of auditing, an Auditor should consider the following points while conducting Audit of Income and **Expenditure of Club**

- The donation received by club will be verified with the counterfoils of receipt, donation register and cash book.
- To verify whether it is a capital donation or a revenue donation, an Auditor should know the policy of the Managing Committee.
- To know the policy regarding membership fees of the new members, an Auditor should check the policy of club, whether membership fees will be treated as revenue receipt or capital receipt.
- Membership fees should be vouched with counter foil of receipts, membership register and cash book.
- Annual subscription of members should be vouched from counterfoil of receipt and cash book.
- On the basis of the members register, annual subscription dues received in advance and arrears of subscription should be reconciled.
- Verification of rent received and outstanding rent may be verified with the rental agreement, receipt book and cash book. An

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Auditor should ensure that the provision for rent outstanding has been provided in books of accounts.

- Income received on account of interest and dividend on investment should be verified with cash book, investment register and documents.
- Bills raised for sports, canteen, health club and restaurant should be verified and he should check the payment against these bills are duly accounted for in cash book and ledger accounts.
- Capital expenditure should be verified from minutes of meeting of managing committee.
- Auditor should verify in due course of audit purchases on account of eatables, sports equipment, health club equipment, general provisions, stationery and printing expenses, etc.
- Staff salary and annual increment to staff should be verified from appointment letters, attendance register, salary register, time records, etc.
- Physical verification is recommended for food items, wines, crockery, sports equipment etc. on the basis of stock register.

Audit of Cinemas and Theatre

Following are the sources of income for cinemas and theatres. We will also understand how the income is to be verified by the Auditor.

- Sale of tickets
- Parking
- Canteen Sale
- Advertisements
- Rental income

An Auditor should verify the income from various sources in the following manner –

- He should verify the rules regarding rates for different class of tickets, free passes, benefit shows, concessional tickets for booking of groups of student of schools and colleges etc.
- An Auditor should ensure that each ticket should be serially numbered.
- Daily collection should be deposited in bank.
- An Auditor should verify the daily return for sale of tickets for different class and different shows from counterfoils of sold tickets.
- He should verify the amount of Entertainment Tax collected on account of sale of tickets.
- Auditor should ensure that Entertainment Tax collected on sale of tickets should be deposited with Government within due time without any fail.

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- Auditor should verify the rate of parking for each class of vehicle.
- Auditor should verify the cash collection on account of parking from issued slips.
- Auditor should ensure that the parking slip should be different for each class of vehicles.
- If parking and canteen are allotted to contractor, an Auditor should examine the contract between client and contractors.
- The payment received from contractor should be verified from the receipt book and the cash book.
- The payment received on account of advertisement should be examined and verified with cash book and receipt book.
- The premises of cinema or theatre may at times be let out on rent. An Auditor should verify the rent received from rental agreement, cash book and receipt book.

Audit of Expenses of Cinemas and Theatre

An Auditor should consider the following points while conducting audit of the expenses of cinemas and theatre –

- An Auditor should verify film hire charges from the terms and conditions of agreement.
- Accounting for the film purchased and the film hired should be done accordingly.
- Film purchased but not shown should be accounted for properly.
- Operating expenses should be thoroughly vouched.
- Outstanding liabilities should be duly provided in the books of accounts.
- Adequate depreciation should be provided on furniture & fixtures of cinemas and theatre. Rate of depreciation should be more than normal depreciation provided in other business.
- Stock of various items should be verified.
- Payment of revenue expenses like electricity, salary and wages, stationery and printing, and purchase of various items should be vouched with available supporting of vouchers.
- Revenue and capital expenditure should be treated accordingly.
- All the books like cash book, petty cash book and ledger accounts should be properly examined.

Internal Control System

An Auditor should examine the internal check and the internal control system of business operations, concerning the cash received, payments made and unsold tickets. He should ensure that the unsold tickets are kept under proper control and in good security conditions. Sold tickets should be duly signed by the authorized officer of the business.

12.2.3 Audit of Hospitals

Maintenance of Accounts of Hospitals

Being non-profit organizations, hospitals prepare Receipt & Payment account, Income & Expenditure account and Balance Sheet; following are various items that fall under income and expenditure in the hospitals.

Main Items of Income

- Room Rent
- Medical Care
- Dentistry Charges
- Delivery Room Charges
- Anesthesia Charges
- Laboratory Charges
- Grants for Operating Needs of Hospital
- Grants for Fixed Assets
- Donations
- Miscellaneous Income
- Interest on Investments
- Fees from Nursing Training School
- Bed Charges
- Operating Room Charges
- X-ray Charges
- Pharmacy Charges
- Physiotherapy Charges

Types of Expenses/ Payments

- Electricity & Water Charges
- Pharmacy Charges
- Salaries and Wages
- Pharmacy Expenses
- Building Repair & Maintenance
- Laundry Charges
- Rent for Nursing Hostel Accommodation (In case of rented premises)
- Telephone Expenses
- Laboratory Expenses
- Surgery Expenses

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- Operation Tools and Equipment Expenses
- Depreciation

Preliminary Audit of Hospitals

An Auditor should follow the below mentioned procedure while conducting Audit of a hospital –

- He should obtain a list of books, documents, register and other records as maintained by the Hospitals.
- He should examine the audit report of last year and should note down qualifications, if any.
- He should examine the system of receiving grants and donations, whether received through cheque or otherwise.
- According to the overall objectives of audit, he should examine the scope of responsibilities.
- He should note down the important clause of Trust Deed or Charter, which may affect the audit and accounts of hospitals.
- He should examine the Minutes of Meetings of the Board of Directors/Trustees or the Managing Committee. He should note down the important decisions concerning the financial transactions relating to fixed assets, investment and financial powers as required by him during his audit.
- He should examine the internal control system regarding purchase of fixed assets, medicines, stores, consumables, clothing and provisions, etc.
- He should examine the internal control system for recording of purchases, issue and storage of all items and physical verification of them.
- He should obtain the rate structure for fees, medicine and other services, power to do concession or waiver of fees. There should be adequate system for charges and waiver.
- He should calculate and examine the input-output ratios.

Audit of Expenses of Hospitals

Vouching of expenses in hospitals is almost the same as in other organizations; however, the following points need to be considered by an Auditor are given below –

- An Auditor should adopt the usual way to vouch purchases and other expenses of the hospitals.
- Clear distinction should be made between capital and revenue expenses.
- Salary of staff should be vouched according to general auditing principles.

Audit of Assets and Liabilities of Hospitals

The Auditor should consider the following points and carefully examine the assets and liabilities of the Hospitals –

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- Title documents and other records relating to land and building should be carefully examined by the Auditor.
- Resolution of Trustees/Managing committee should be verified for sale and purchase of fixed assets.
- Depreciation should be charged on the basis of the policies of the Managing Committee.
- Liabilities should be verified in the usual manner.
- An Auditor should physically verify the investments like shares, debentures, bonds and security certificates. He should also verify them with the investment register.
- Stock and stores of medicines, clothing, consumables, etc. should be physically verified at the end of the year.

Audit of Income of Hospitals

An Auditor should consider the following points and carefully examine the income/receipts of the hospitals –

- An Auditor should check the bill book, bill register and copy of bills.
- It should be verified that bills are prepared properly according to visit charges of doctors, medicine, stay charges, room rent, etc.
- Bills should be verified with the fees/charges structure.
- Concession and waiver on account of fees and other charges should be verified.
- Bills should be verified with cash receipt book, counterfoil of receipts and cash book.
- Verification of arrears of bills should be done.
- Unrecoverable arrears should be written off with the approval and consent of proper authority.
- Rental income should be properly verified. He should properly vouch property register, arrear of rent, advance rent and provisions for the same.
- Interest and dividend income should be verified with investment register, cash book and share warrants, etc.
- Documents and correspondence relating to donations and grants should be verified; the list of donors, grant sanction letter should be obtained to verify the same.
- Unutilized grant should be verified at the end of the year. In case of non-fulfillment of conditions, grant will be taken back by the authority.
- Distinction between revenue and capital donation should be checked and verified. In case donation is for some specific purpose, the Auditor should assure that the money is used for the same purpose only.

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12.3 CHECK YOUR PROGRESS

1. How would you audit the receipts of hospitals?
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2. How would you check payments made by cinema theatre?
.....
3. How would you audit hotels?
.....

12.5 SUMMARY

This chapter deals with how the audits verify the different special institutions accounts and how the accounts are maintained in the institutions

12.6 KEY WORDS

Audit manual : It is defined as a written internal auditing document providing different information as to detailed auditing procedures. Object of auditing standard of performance, time recording procedure, preparation of audit report etc.

UNIT XIII LIABILITIES OF AN AUDITOR

Liabilities of an Auditor

- 13.0 Introduction
- 13.1 Objectives
- 1.32 13.2 Liabilities Of An Auditor
 - 13.2.1 Damages Civil Liability
- 13.3 Self assessment questions
- 13.4 Summary

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13.0 INTRODUCTION

Code of conduct refers to a set of professional and ethical standard regulating the relationship of shortened accountants with their client employed, employee, fellow members of the institute and general public

13.1 OBJECTIVES

Highlights the ethical aspects of connected with auditor.

13.2 LIABILITIES OF AN AUDITOR

Liabilities of an auditor of a company differ from those appointed by a firm, The Companies Act has defined the duties of a company auditor and the liabilities arise on account of these duties. For the sake of convenience the liabilities are divided under the following headings:

- A. Civil Liability;
- B. Criminal Liability;
- C. Liability towards third parties;
- D. Liability for libel;

In all the four cases the auditor can be held liable for one or more causes given hereunder.

- (a) Liability for Negligence under the law of Agency;
- (b) Liability for Misfeasance under the Statutes—Companies Act and Indian Penal Code. Let us now discuss these liabilities in some detail.

13.2.1 Damages Civil Liability

Liability for Negligence: Under the law of Agency the auditor is liable for negligence and in such a case has to pay damages to the aggrieved party or parties. If the company suffers a loss on account of the acts of the auditor, he has to make good this loss. The auditor shall not be held liable for negligence, if the company does not suffer any loss. He shall also not be held liable for the loss suffered by the company without his negligence. In order to hold him responsible for negligence, the following points are to be proved by the party (ies).....

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- (a) that he was negligent;
- (b) that as a result of his negligence the company has suffered the loss ; and
- (c) that the loss was suffered by the person to whom the auditor owed a duty. He cannot be relieved of his liability by an agreement entered in between him and his client.

'Negligence' includes the following acts—

- (a) Not to see the Articles of Association and not to object payment of dividends out of capital;
- (b) Not to get statements of accounts from the creditors and find out the errors and frauds.
- (c) Not to verify Cash and Petty Cash;
- (d) Not to report to the client about the insufficient provision for bad and doubtful debts, which results in inflating the profits for dividends, thus paying dividends out of capital.

Liabilities for Misfeasance : The term 'misfeasance*' implies a breach of trust or duty. Where the auditor performs his duties negligently and the company suffers a loss on this account, the auditor is held liable for Misfeasance and he has to indemnify the company for such loss. He is also liable for damages u/s 543 of the Companies Act. The court can, on application made by the liquidator of the Company, charge the auditor for misfeasance and ask him to make good the loss. However, the auditor has a right to appeal to the court u/s 633 of the companies Act and he can be excused partly or fully by the court if it is satisfied that he has acted honestly and reasonably. Thus relief can be granted only in the case of Civil liability and not in the case of Criminal liability.

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 : He is criminally liable, when he issues or signs a certificate required by law to be given or signed or relating to any fact for which such certificate is admissible as evidence, knowing or believing that such certificate is false in any material point. He shall be punishable in the same manner as if he has given false evidence. (Section 197).

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

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(a) for authorising the issue of a false prospectus. The penalty for this act is a fine upto Rs. 50,000/- or imprisonment upto a period of 2 years, or both. (S. 63)

(b) for fraudulently inducing persons to invest money by purchasing shares or debentures of the company. The punishment is imprisonment for a term extending upto 5 years or a fine extending upto Rs. 1,00,000/- or both. (S. 68).

(c) for making a fraudulent report required under section 227 i.e. if the report is made not in conformity with the requirements of Section 227 or any document of the company is signed or authenticated by him which is also not in conformity with the above section or the report is signed or any other document is signed or authenticated by any person other than the auditor himself and such other person is not authorised to do so. The punishment is a fine upto Rs. 10,000 in both the above cases.

(d) For falsification of books. If it is proved that the auditor has been guilty of destroying, mutilating, altering, falsifying or secreting of any books, papers or securities or is privy to the making of any false or fraudulent entry in any register, book of account or document belonging to the company, he shall be punishable with imprisonment extending to seven years and also be liable to fine. (Section 539).

(e) for delinquency i.e. making a false statement wilfully, in the course of winding up of the company or certifying a false return, report, balance-sheet or giving a false certificate or certifying a false document in the course of winding up of a company. All these acts make him liable for criminal offences and the liquidator can directly prosecute him or refer the matter to the Registrar. (Section 545).

(f) For rendering false statements either in the balance sheet or any other document or destroying or mutilating any voucher or document, the auditor shall be punishable with imprisonment upto a period of two years and also shall be liable to fine.

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

- a. Wilfully submitting a false report;
- b. Concealment of frauds in the account books;
- c. Destroying the vouchers and documents concerning account books;
- d. damaging the property of the company;
- e. Abetting in the falsification of the account;
- f. Certifying wilfully the false accounts;
- g. Making a false statement knowingly to be false;
- h. Accepting bribe during the course of discharging his duties as an auditor.

3. Under the Income tax Act: The auditor is criminally liable for encouraging or abetting his client to make a false statement or declaration regarding his taxable income. The liability for such offence is imprisonment upto 6 month or fine or both. (Section 278).

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4. Under the Life Insurance Corporation Act: The auditor is criminally liable for making a false statement wilfully on a material point relating to the return, report, balance sheet or any document. The punishment is imprisonment and fine. (Section 104).

5. Under the Banking Companies Act: The auditor is criminally liable, if he makes a false statement knowingly relating to a return, report, balance sheet or any other document or conceals a fact. The punishment is imprisonment upto a period of three years. (Section 46).

Auditor is treated like a public servant and shall be punishable like a public servant for criminal breach of trust. (Section 46 A). He is also liable to Public Examination and if found guilty by a court can be declared unqualified for appointment as an auditor for 5 years. (Section 46 A).

6. Under the Chartered Accountant Act, 1949 : the auditor is liable for misconduct, which is defined under section 122 of the Act. Cases of professional misconduct are dealt in the various schedules of the Act.

C. Liabilities Towards Third Parties

Auditor is not liable to third party or parties as a general rule. He is liable to his employer only. However, if the third parties are able to prove the following points he shall be liable towards them too—

- (a) that the statement was untrue in fact;
- (b) that the person making it knew that it was untrue or was recklessly can consciously ignorant whether it was true or not;
- (c) that the statement was made with the intention 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 whether the auditor is liable to the third party is now set at rest and the auditor is now held liable on account of the following reasons—

- (a) Certifying the improper accounting procedure due to which embezzlement of an employed of the client could not be detected.
- (b) Negligence committed by the employee of the auditor;
- (c) Errors committed in the preparation of final accounts,

1) Liability for Libel

A libelous or slanderous statement made by an auditor will not hold him liable if he has made such statement bonafide and without any malice. But if he has made such a statement outside the scope of his duties, he shall be held liable.

Liability of an honorary Auditor

An auditor, whether he is paid or honorary, is liable for his acts and omission. The agreement with his client is very much valid in the eye of the law even though there is no monetary consideration involved.

Liability of a Joint Auditor

The Companies Act is silent over the issue. But the statement issued by the Institute of Chartered Accountants of India, on the subject of the liability of Joint Auditors is to be followed in such cases. The gist of this statement is ; the entire work pertaining to audit is to be divided in between the auditors and they shall be responsible for their part only, where the work cannot be divided in any manner, all joint auditors will be responsible.

Liability of Local Auditors

If a company has many branches in the country as well as abroad and appoints local auditors for the branches, the auditor of the Head Office shall not be held responsible for the acts of the local auditors, provided the auditor at the Head Office states clearly in his audit report that he had completely relied upon the statements and figures supplied by the local auditors.

13.4 Qualities of an Auditor

An Auditor must have the following qualifications and qualities –

- He should be a qualified Chartered Accountant or he should be a qualified member of The Institute of Cost & Works Accountants of India to do cost audit.
- He must have adequate skills and qualities to conduct his work efficiently.
- An Auditor must be honest, impartial and unbiased. He should also be hard-working, have adequate common sense, capacity to hear arguments of others, systematic and methodical.
- An Auditor should ask for clarification on matter on which he is unable to understand the information provided to him.
- His audit report should be correct and clear.
- In case where any suspicious situation arises, he should assume that he is dealing with dishonest and fraudulent peoples.
- He must have thorough knowledge of accounting principles and practices.
- He must have the know how of all the domestic and international court case decisions.
- He must have thorough knowledge of financial management, industrial management and business organizations.
- He must have up-to-date knowledge of the Mercantile law and the Companies Act.

13.3 CHECK YOUR PROGRESS

1. Explain the civil and criminal liability of a auditor.
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2. Explain the liability of an auditor for negligence.
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3. What are the circumstances under which an auditor is liable to a third party?
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13.4 SUMMARY

The liability of an auditor may be divided as:

1. Liability under the Statute: It may be the following:

- (a) The Companies Act, 1956
- (b) The Indian Penal Code

2. Liability for negligence under the Law of Agency

• Under the Companies Act, 1956: As regards the liability under the head, the liability of an auditor can be divided as:

- a. Civil Liability
- b. Criminal Liability

Civil Liability Under Section 2(30) of the Act, the term 'officer' includes an auditor for the purposes of Section 477,478,539,543,545,621,625 and 633. This implies that the auditor is liable under these Sections as an officer of the company.

Criminal Liability Under the Companies Act: Section 57 provides that a prospectus shall not include a statement purporting to be made by an expert (which expression includes an accountant), unless he is not or has not been engaged or interested in the formation of promotion or in the management of the company. Under section 59, every person who is knowingly a party to the issue of a prospectus in contravention of Section 57. is punishable with fine which may extend to Rs. 5000.

Section 68. provides penalty for fraudulently inducing persons to invest moneys, A fine up to Rs. 10,000 and/or imprisonment up to 5 years may be awarded to a person guilty of inducing.

In order to hold an auditor criminally liable, the following must be proved

- a. That the Statement made was false in material facts.
- b. That the auditor willfully made such a false statement.
- c. That the statement complained of has been made in any return, document report, balance sheet, certificate or any other Companies required to be made under any provisions of the Act.

Ethics is the foundation of a civilized society and is a preliminary requirement of what a civilized person expects from other civilized persons. A business or profession that checks the compliance of ethics is bound to fail sooner or later.

UNIT XIV AUDIT OF SPECIAL INSTITUTION AND INVESTIGATION

*Audit of Special
Institution and
Investigation*

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- 14.0 Introduction
 - 14.1 Objective
 - 14.2 Audit of Computerized Accounts
 - 14.2.1 Computer based accounting system
 - 14.2.2 Computerized Accounting system
 - 14.3 14.3 Investigation under the provisions of companies act
 - 14.4 Self Assessment Questions
 - 14.5 Summary
 - 14.6 Keywords
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4.0 INTRODUCTION

Investigation donotes specific enquiry into book of accounts and record to accomplish specific objectives, in most of the carrier investigation aimed at ascertaining the financial status and profile earning capacity of business enterprises.

14.1 OBJECTIVE

Throw light on the various aspects relating to investigation

14.2 AUDIT OF COMPUTERIZED ACCOUNTS

1. The auditor's job is made easy hanks to computerisation. He is relived from the work of tedious nature.
2. It helps the auditor to save time and manual labour to a great extent.
3. Management is able to arrive at any decision quickly as the computerized environment provides data in any format in quick time.
4. Electronic data interchanges and audit softwares have substantially reduced the work of auditor in audit environment.
5. Bank balance can be checked and confirmed online.
6. Voice recognition system and scanners have given place to traditional data entry which is vulnerable to errors and fraud. This has reduced the scope for such errors and fraud.
7. The real time processing has spectacularly bettered the inventory management and share market operations.
8. Computer –aided software engineering and data base management system help the auditor in no small measure in auditing exercise.

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14.2.1 Computer based accounting system

Organizational Control

CIS function should be so organized as to weed out incompatible function to the extent possible. Segregation of duties helps in organizational control.

- a) System Designing : This involves designing new system or modifying the existing one to the needs of the enterprise. System analyst would take care of this function.
- b) Programming: The programme is developed for the design by the programmer. He tests the programme and modifies it in term of modification suggested by system analyst.
- c) Computer operations: Computer operator has to run the programmes as per the commands incorporated in the programme. Them programmes should be designed in such a way that one cannot tamper with the records.
- d) Data maintenance: There should be an officer in whose control all programme files and transaction files should be entrusted.

14.2.2 Computerized Accounting system

1. Physical observation of the process of auditing is absent in Computerized accounting system.
2. Unscrupulous employees may back the system, password and security infrastructure and commit fraud.
3. There may be mismatch between system code and object code thereby causing problem to auditors.
4. The auditor may not be able to track down source data as source document, intermediate document and report are eliminated. Audit trail is fading away, thanks to computerization.
5. Auditors face constraints in concurrent audit of banks and other big institutions where real time processing is under practice. Poor infrastructural inadequacy hinders the flow of audit in a computerized environment.

14.3 INVESTIGATION UNDER THE PROVISIONS OF COMPANIES ACT

It implies an enquiry into the accounts and records of a business undertaking. It is a sort of special audit with a particular object in view. Investigation involves inquiry into facts behind the books and accounts, into the technical, financial and the economic position of the business or organisation. Investigation is an examination of books and records preliminary of financing or for any specified purpose, sometimes differing in scope from the ordinary audit. Investigation implies an examination of and record for some special purpose. Nature of Investigation Investigation is an enquiry into the financial statements of a number of past years with a view to know the real financial position or earning capacity. It is in fact a kind of special audit with predetermined scope depending upon the purpose to be achieved. Investigation is neither accounting nor auditing. Investigation is carried out not in substitution of

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audit, but in addition to audit. The investigating auditor may even have to investigate the audited accounts. Scope of investigation No general principle can be laid down with regard to the scope of every type of investigation. Scope of investigation, in each case, would be limited to the period or area to be covered by the investigator. An investigation on behalf of a person intending to purchase running business of a sole trader will be restricted to the determination of value of assets, liabilities, reserves, existing potential and future prospects. An investigation to settle suspected irregularities in cash or stock would normally cover a period from three to six months.

Objectives of Investigation The real objective of conducting an investigation by an auditor on behalf of his client is to provide him the desired information in the form of a report about the matter specified. Normally the objective of investigation is to collect, analyze and evaluate facts in respect of desired field of activity with a view on some special purpose as determined by the person on whose behalf the investigation is undertaken. In short investigation is to ascertain the financial position and earning capacity of a business on behalf of a certain person.

The common objectives of investigation are listed below:

- 1) Proposed purchase of business.
- 2) Proposed sale of business.
- 3) Reasons for low profitability.
- 4) Cause of high employee turnover.
- 5) Reliability of business data.
- 6) Proposed investment in particular securities.
- 7) Suspected fraud.
- 8) Joining in existing partnership business.
- 9) Borrowing funds.
- 10) Lending funds.
- 11) Proposed purchase of controlling shares in a company.
- 12) Suspected misfeasance against directors.

Difference between Audit and Investigation:

1. **Legal binding** Audit of annual financial statements is compulsory under the Companies Ordinance, 1984. Investigation is not compulsory under Companies Ordinance but voluntary depending upon necessity.

2. **Object in view** Audit is conducted to ascertain whether the financial statements show a true and fair view. Investigation is conducted with a particular object in view, viz to know financial position, earning capacity, prove fraud, invest capital, etc.

3. **Period covered** Audit is conducted on annual basis. Investigation may be conducted for several years at a time, say three years. 4. **Parties for whom conducted** Audit is conducted on behalf of

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shareholders (or proprietor, or partners). Investigation is usually conducted on behalf of outsiders like prospective buyers, investors, lenders, etc.

5. Documents Audit is not carried out of audited financial statements. Investigation may be conducted even though the accounts have been audited. 6. Extent of work Audit is normally conducted on test verification basis. Investigation is a thorough examination of books of accounts.

7. Report Audit report is addressed to shareholders (or proprietors or partners). Investigation report is addressed to the party on whose instruction investigation was conducted. 8. Adjustment in net profit In case of audit net profit disclosed by audited accounts is final without further adjustments. In case of investigation in order to determine real earnings certain adjustments are always essential. 9. Person performing work Audit is to be conducted by a chartered accountant.

14.4 Electronic Data Processing

Electronic data processing is a frequently used term for automatic information processing. It uses the computers to manipulate, record, classification and to summarize data. A computer is the best example of an **electronic data processing** machine. **Electronic data processing** is an accurate and rapid method.

Methods of Electronic Data Processing

- Time-sharing
- Real-time processing
- Online processing
- Multiprocessing
- Multitasking
- Interactive processing
- Batch processing
- Distributed processing

Related: Data Processing | Meaning, Definition, Steps, Types and Methods

Time- Sharing: In this processing method, many nodes connected to a CPU accessed central computer. A multi-user processing system controls the time allocation to each user. Each user can allocate the time slice in a sequence of the Central Processing Unit. The user should complete the task during the assigned time slice. If the user cannot finish the task, then the user can complete the task during another allocated time slice.

Real-Time Processing: Providing accurate and up-to-date information is the primary aim of real-time processing. It is possible when the computer process the incoming data. It will give the immediate response what may happen. It would affect the upcoming events. Making a reservation for train and airline seats are the best example for real-time processing.

If the seats are reserved, then the reservation system updates the reservation file. The real-time processing is almost an immediate process to get the output of the information. This method saves the maximum time for getting output.

Online Processing: In this processing method, the data is processed instantly it is received. A communication link helps to connect the computer to the data input unit directly. The data input may include a network terminal or online input device. Online processing is mostly used for information research and recording.

Multi-Processing: Multiprocessing is processing of more than one task that uses the different processors at the same time of the same computer. It is possible in network servers and mainframes. In this process, a computer may consist of more than one independent CPU.

There is a possibility to made coordination in a multiprocessing system. In this process, the different processors share the same memory. The processor gets the information from a different part of one program or various programs.

Multitasking: It is an essential feature of data processing. Working with different processors at the same time is called multitasking. In this process, the various tasks share the same processing resource. The operating systems in the multitasking process are time-sharing systems.

Interactive Processing: This method includes three types of functions. The following are the types of function

1. Peak detection
2. Integration
3. Quantitation

It is a simple way to work with the computer. This method of the process can compete for each other.

Batch Processing: Batch processing is a method of the process the organized data into divided groups. In this method, the processing data can be divided as a group over a required time period. The batch processing method allows the computer to perform different priorities for an interaction. This method is very unique and useful to process.

Distributed Processing: This method is usually used for remote workstations, since the remote workstations are connected to a big workstation. The customers get the better services from this process. In this process, the firms can distribute the use of geographical computers. The best example for this distributed processing method is ATMs. ATMs are connected to the banking system.

Elements of Electronic Data Processing

Hardware, Software, procedure, personnel is the basic elements of electronic data processing. In the hardware section, scanners, barcode scanners, cash registers, personal computers, medical device, servers, video and audio equipment are the elements of electronic data processing. In the software section, accounting software, data entry,

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scheduling software, analytics, and software are the elements of **electronic data processing**. In the procedure section, sorting, analysis, reporting, conversion, data collection, aggregation be the elements of EDP.

Stages of Electronic Data Processing

A collection is the first stage of **electronic data processing**. It is a very crucial part. This process ensures that accurate data gathering. Census, sample survey, and administrative by-product are some types of data collection. Preparation is the second stage of electronic data processing. Preparation is used to analyze the data processing.

Input is the third stage in **electronic data processing**. Data entry is done by the use of a scanner, keyboard, and digitizer. The fourth stage is processing. It has various methods. The last stage is storage. Every computer has the use to store the file.

Advantages of Electronic Data Processing

- The system of electronic data processing is once created then the cost of the managing data will be reduced. Documents can be protected as an extreme data sensitive. Because of the documents should be treated as a primary asset. When all the information is collected by the papers are the challenging one.
- The management of document is costly. So, electronic data processing reduces the cost of the paperwork. The electronic data processing provides the documentation controls. With the help of electronic data processing, you can easily automate the PDF publishing process.
- In electronic data processing, there is a facility to search a document in the system. It will reduce the time loss. The electronic data processing has the benefit to improve the internal and external collaboration. The electronic data processing helps to improve the better submissions. The electronic data processing also fast up the complete structure to make the generation of documents.
- The famous software product such as Ms. Office is using the electronic data processing concept. The EDP has the facility to reduce the duplication of effort and repeated entries. The EDP has the capability to make the decisions. An electronic data processing has the ability to store the enormous amounts of data.

Disadvantages of Electronic Data Processing

- When the computer hackers make the strike on the computer, then the processing of data will make the insecurity. Then the data will be the loss. The fault in a equipment will harm all the equipment in the office. The security of the computer would be the big problem. In a coding process, a computer not recognizes the same individuals.

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- When a small number of digit codes are compared with a large number code then, it occupies the computer storage less. The alphabetic codes can be descriptive.

Examples of EDP: It is used in a telecom company to format bills and to calculate the usage-based charges. In schools, they use EDP to maintain student records. In supermarkets, used for recording whereas hospitals use it to monitor the progress of patients.

Further, the **electronic data processing** is used for hotel reservations. It can be used in learning institutions. The EDP is also used in banks to monitor the transactions. In the departments such as police, cybercrime, and chemical the electronic data processing is used to note the entries. It enables larger organizations to collect the information and process the data. The electronic data processing can also be used as video and audio equipment. It can be used as a barcode scanner.

14.5 CHECK YOUR PROGRESS

1. Enumerate the purpose for which investigation is undertaken
.....
2. Explain the process of conducting an investigation.
.....
3. What are the steps in Audit of computerized accounts?
.....
4. Explain the role of auditor in computerized auditing.
.....

14.6 SUMMARY

Electronic data processing involves processing data through computer . A large number of business accounts have further over to computerized accounting. As a result an auditor has to deply computer aided audit technique.

14.7 KEYWORDS

Investigation : It may be defined as a special examination of and enquiry into books of accunts and other related records with a view to establishing a fact or to evaluating a state of affairs or to deterring career for a happening in business

Interim Audit: Audit conducted in between the two annual general meeting is called interim audit.

Fraud : It means false representation or entry made intentionally or without belief in truth with a view to defrauding other.

MODEL QUESTION PAPER

Model Question Paper

AUDITING

Time : 3hrs

PART - A

Max marks:75

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I. Answer all the questions not exceeding 50 words each.(10 x 2 = 20)

1. Define an Audit, State the various objects of an audit.
2. Difference between accountancy and Auditing .
3. Define audit evidence and its objectives.
4. Explain the essentials of good audit evidence
5. Explain the scope of audit
6. Define Internal control.
7. What is mean by internal check?
8. Explain the limitation of internal control .
9. State the difference between internal audit and independent financial Audit.
10. Define operational audit.

PART – B

II. Write any FIVE questions of the following not exceeding 650 words each.

(5 x 5 = 25)

11. Define vouching and explain its objects.
12. What is the distinction between goods sold on assignment basis and on sale or return basis.
13. Why should the auditor be concerned with purchase returns?
14. What are the documents to be examined while vouching purchases.
15. What is a voucher? What consideration or points should auditor keep in mind while examining a voucher?
16. Discuss the procedure for vouching the items appearing on the debit side and credit side of cash book.
17. How will you vouch the Bought ledger and sales ledger of a manufacturing concern?
18. Enumerate the purpose for which investigation is undertaken

PART - C

III. Answer any ONE from each section of the following not exceeding 1500 words each (2 x 15 = 30)

19) (a) What are the circumstances under which an auditor is liable to a third party?

(or)

(b) What are the qualifications prescribed for an auditor of a limited company? State the mode of appointment of casual vacancy of an auditor?

20) (a) State the procedure an auditor should follow to verify the issue of shares for cash and consideration other than cash?

(or)

(b) Explain the statutory provision with regard to appointment and remuneration of auditors of a limited company?

Model Question Paper

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